

Will “Bharat Financial Inclusion” Rise From the Ashes? Analysis of M&A and Emerging Issues

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Bharat Financial Inclusion Ltd. (erstwhile SKS Micro Finance) has been in talks of a merger with IndusInd Bank in an attempt to revive itself as a vertical of IndusInd, in the form of NBFC in September 2017. The deal is of a size and complexity that has not been seen for long time between the second largest microfinance company in the economy and IndusInd Bank, a leading private sector bank. BFIL has entered into an “exclusivity agreement with IndusInd Bank for due diligence and discussions to evaluate a potential strategic combination between the two organizations”. The shares of both the companies surged as the announcement of exclusivity agreement was made in the press. This case study is unfolded as follows: The first part would detail the history of BFIL and IndusInd Bank. Further discussion would dwell on the merger deal and the impact on stock markets. The potential benefits for the two would be laid out in the conclusion.

Keywords: merger, exclusivity agreement, microfinance, synergy, market impact, due diligence

INTRODUCTION

Bharat Financial Inclusion Ltd (BFIL)

SKS Micro finance (Swayam Krishi Sangam) a Non-Governmental organization founded by Vikram Akula (son of a US based surgeon) in 1997 commenced its operations in Tumnoor (Medak District, Andhra Pradesh). SKS later became a leader among its peers as a micro lender with high growth in loans to farmers in Andhra Pradesh and other states. Its growth can be primarily attributed to the reluctance of commercial banks to serve the financial needs of poor customers who were not part of the formal banking system. It morphed into a non-banking financial company (NBFC) in 2005, mainly because of its founder’s efforts. Five years later, SKS became the only micro finance lender to be listed on stock exchanges. SKS secured the first round of equity of \$ 11.5 million from funders led by Sequoia Capital and in the following year raised \$ 75 million, the largest ever funding by a MFI till date. Soon, Catamaran Ventures (a venture capital firm floated by Infosys founder N R Narayanmurthy and others) invested in SKS. In August 2010 it announced its Initial Public offer (IPO) which was oversubscribed 14 times. It becomes the first

microfinance company (MFI) in South Asia to become public. The success of SKS led to talks with other companies in MFI sector and led other companies to follow its leader to tap the capital markets.

Farmers in Andhra Pradesh provided a fertile environment for the expanding SKS and other MFIs, because the women SHG movement strengthened by State Governments and had brought millions of rural women into the fold of Joint Liability Groups (JLG), creating far greater demand for credit than what the banks were willing to offer. Lending to JLG was the core business model adopted by SKS. However, the situation went into reverse after the state Government of AP took action against the MFIs for their high interest rates, coercive recovery practices, multiple lending to the same family without bothering the repayment capacity and other excesses committed by MFIs. **The party `was short lived not only for the company but also for the micro finance industry!** Microfinance crisis erupted in Andhra Pradesh after the worst ever famine in Andhra Pradesh. In September 2010 just before the micro finance crisis exploded SKS's exposure to Andhra Pradesh was over 27 % of its total loan book, it's highest in any state. In October 2010, 30 poor farmers and their families committed suicide within a period of 45 days. Among these 30 women, 17 were reported to be borrowers of SKS Micro finance who could not pay their interest and loan instalments. Micro finance crisis loomed large in Andhra Pradesh state and the AP Government promulgated its "Micro Finance Institution (Regulation of Money lending) Ordinance" in October 2010 to protect poor farmers from coercive recovery practices of MFIs. Vikram Akula steps down as Chairman in 2011.

- ❖ SKS became "Bharat Financial Inclusion Ltd (BFIL)" and goes on to restructure itself into an NBFC. The stock markets also did not take it kindly. Its share price falls from Rs.1400 to about Rs.54 a share (face value Rs. 100). In the years that followed SKS Micro Finance provided fully for the outstanding exposure in Andhra Pradesh, wrote off Rs.1360 Crore in the state and stopped fresh disbursements in the State. "It had a long lasting adverse effect, but BFIL was an exception. BFIL met all its commitments to the lenders including the banks on time and never went into Corporate Debt Restructuring (CDR)" said it's non-executive Chairman P.H. Ravikumar (erstwhile Executive Director, ICICI Bank Ltd). A year later in 2011, the Reserve Bank of India (RBI) put in place regulations based on the recommendations of a high powered Committee headed by the eminent Chartered Accountant Y.H.Malegam. The norms capped the margin between the cost of borrowing and the price at which the loans were provided and interest rates were regulated. Despite this, BFIL maintained its growth momentum. Assets under management (AUM) consisting of non- Andhra exposure grew at a compounded annual growth rate (CAGR) of 46 % between fiscal 2013 and 2017. Though it reported losses due to write offs on loans to farmers in AP, BFIL swung back to profits a year later in 2013-14. However, demonetization impacted the collection of loans, which forced BFIL to make higher provisions in 2015-16. Thus BFIL had seen a sharp rise in non-performing assets due to demonetization. The withdrawal of high-value notes in November 2016 triggered a countrywide cash crunch, hurting loan recoveries. However, after making the requisite provisions BFIL's EPS and Book Value stood at Rs. 21.56 and Rs.177 respectively. In June 2017, a chunk of BFIL's assets are in the form of loans in Odisha, Bihar, West Bengal, Karnataka and Maharashtra. Thus, the history of BFIL has been tumultuous and often found to be erroneous by RBI and the Government to deny the licence of Small Finance Bank (SFB). To Cap all these woes, BFIL now faces the unprecedented situation of take-over by IndusInd Bank! **Will BFIL rise from the Ashes?**

TABLE 1
FINANCIALS OF BFIL

(Rs.Cr)

Particulars	FY17	FY16	FY15	FY14	FY13	FY12	FY11	FY10	FY09
Income from Operations									
Interest income on loans	1,228	954	566	393	220	359	1,031	761	450
Excess interest spread on securitization	172	110	67	56	58	35	119	96	48
Other Income	328	257	170	96	75	78	120	102	56
Total revenue	1,728	1,321	803	545	353	472	1,270	959	554
Financial expenses	622	485	279	214	143	200	350	288	194
Personnel expenses	406	292	232	166	173	261	326	216	136
Provision and write-offs	359	39	10	15	244	1,173	236	51	13
Other Expenses	770	596	367	294	233	362	537	424	280
Total expenditure	1,535	927	609	475	650	1,796	1,099	691	429
Profit before tax	193	394	194	70	-297	-1,324	171	268	125
Tax expense	109	91	6	0	0	37	59	94	44
Profit after tax	290	303	188	70	-297	-1,361	112	174	80
EPS - Diluted (INR)	21.56	23.33	15.04	6.47	-30.6	-188	15.24	27.3	16.2
Book Value (INR)	177	109	83	42	36	60	246.23	147.27	136.7
No. of shares outstanding (crores)	13.8	12.73	12.63	10.8	10.8	7.2	7.23	6.45	4.79

Note: Amounts consolidated and rounded off wherever necessary.

Source: BFIL Website

IndusInd Bank Limited, established in 1994, provides commercial banking and foreign exchange products and financial services. IndusInd bank commenced its operations with a capital of Rs. 1 billion among which Rs. 600 million was invested by the Indian Residents and Rs. 400 million was raised by the Non-Resident Indians. The bank has specialized in retail banking services and continuously upgrading its support systems by introducing newer technologies. It is also working on expanding its network of branches across the country and meeting the global benchmark. As on June 30, 2016, IndusInd Bank has 1,004 branches, and 1885 ATMs spread across 625 geographical locations of the country. It also has representative offices in London, Dubai and Abu Dhabi. Mr. R. Seshasayee, is the current Chairman and Mr. Romesh Sobti is presently the Managing Director and CEO, who took charge from Mr. Bhaskar Ghose in 2007. IndusInd Bank has the employee strength of about 23,000 (March 2017).

IndusInd Bank operates the clearing bank status for both major stock exchanges - BSE and NSE - and major commodity exchanges in the country, including MCX, NCDEX, and NMCE. IndusInd Bank was included in the NIFTY 50 benchmark index. IndusInd Bank is ranked 19th amongst the Top 50 Most Valuable Indian Brands 2014 as per Brand Z Top 50 rankings powered by the WPP and Millward Brown. (March 2017)

IndusInd Bank Ratings Scenario as of April 2017

- ❖ ICRA AA for Upper Tier II subordinate debt program by ICRA
- ❖ CRISIL A1+ for certificate of deposit program by CRISIL
- ❖ IND A1+ for Short Term Debt Instruments by India Ratings and Research
- ❖ IND AA+ for Lower Tier II subordinate debt program by India Ratings and Research
- ❖ IND AA for Upper Tier II subordinate debt program by India Ratings and Research
- ❖ IND AA+ for senior unsecured bonds program by India Ratings and Research

TABLE 2
OPERATIONS PERFORMANCE - HIGHLIGHTS AT A GLANCE

Particulars	Q4 FY17 (Rs. Cr.)	Q 4 FY16 (Rs. Cr.)	Y-o-Y Growth (%)	FY2016-17 (Rs. Cr.)	FY2015-16 (Rs. Cr.)	FY 2014-15 (Rs. Cr.)
Net Interest income	1,667.45	1,268.21	31	6,062.60	4,516.57	2890.71
Non-Interest income	1,211.30	912.80	33	4,171.49	3,296.95	1890.53
Operating profit	,572.23	1,151.19	37	5,451.01	4,141.42	3071.73
Net Profit	751.61	620.35	21	2,867.89	2,286.45	1408.02

Note: Q –Quarter, FY – Financial Year, Y-O-Y – Year over Year, Rs.Cr.-Rupees in Crores

Source: IndusInd Bank Website

PRESENT STATUS OF MICROFINANCE INDUSTRY

Microfinance institutions (MFIs) came into being in the 90s due to banks' reluctance to lend the persons without a credit history. It provided an opportunity to those willing to take a risk and organize rural communities. The basic statistics of Microfinance is given here under:

- India has some 223 MFIs (including societies and NGO-run entities).
- Presently, there are about 47 NBFC-MFIs covering 90% of the loan portfolio.
- Microloan outstanding as on June 2017 is about Rs 1.20 lacs Crores
- MFIs don't have access to deposits and hence their cost is high.

RBI has imposed many restrictive conditions like a cap on interest rates and multiple lending to single borrowers thereby making it difficult for Microfinance Industry to survive. It is already in a consolidation phase and many companies had been acquired by Banks / NBFCs. Major Acquisitions taken place so far are,

- Kotak Mahindra Bank acquired 99.5% in BSS Microfinance
- IDFC Bank acquires GramaVidyal Microfinance
- Netherlands based Credit Access Asia holds 99% in Grameen Koota
- MuthootFinance holds 64% in Belstar Investment and Finance
- Manappuram holds 90.38% in Asirvad Microfinance

K. C. Chakrabarty (formerly Deputy Governor, Reserve Bank of India) once said that “micro lenders may become irrelevant if banks turn efficient.”

MERGER DEAL

BFIL and IndusInd Bank had commenced the talks of a merger and signed an exclusivity agreement for proposing a strategic combination by way of amalgamation /merger whichever suits both. Currently 98.37 per cent of BFIL are held by the public and 86.33 per cent of these shares are with foreign portfolio investors which include Morgan Stanley Mauritius Co. Ltd, East Bridge Capital Master Fund Ltd, Mathews India Fund, Amansa Holding Pvt. Ltd and BNP Paribus Arbitrage. Though it was reported that a swap ratio of one share of IndusInd Bank for 1.75 shares of BFIL was agreed upon, both parties refused to provide the

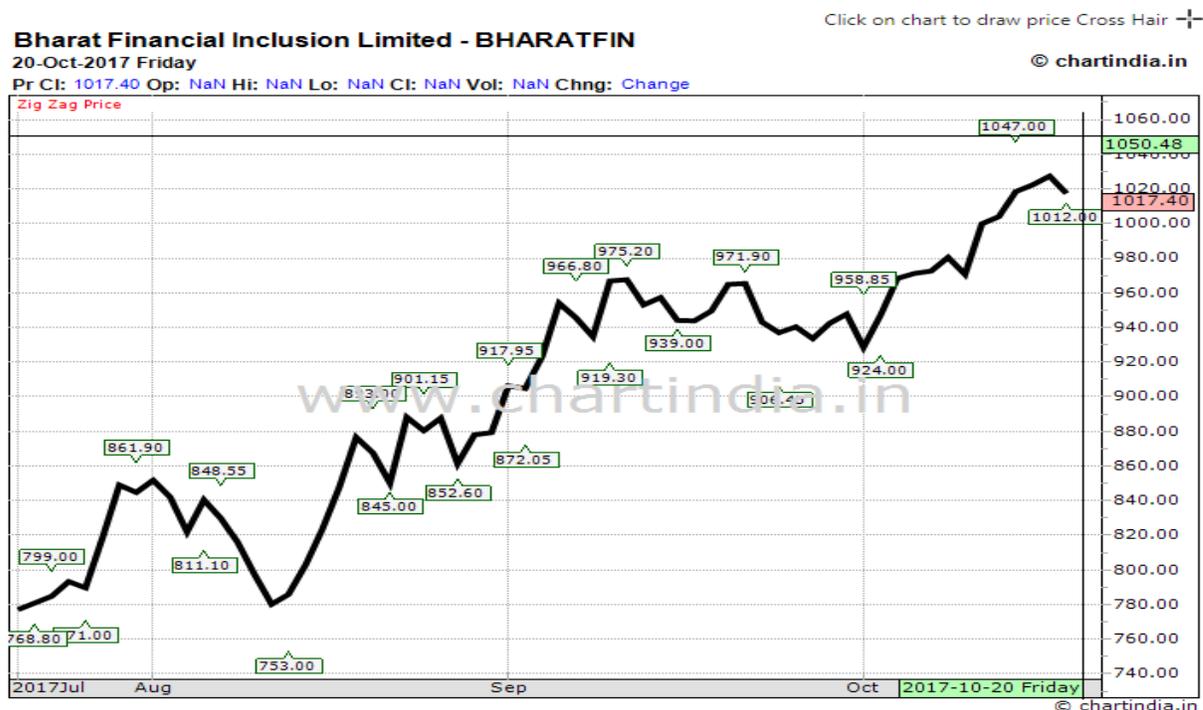
details of whether IndusInd Bank would make an open offer for BFIL shares or it would be an all-stock deal. Finally on October 14, 2017 the deal between IndusInd Bank and BFIL was approved at the Board Meeting of IndusInd Bank. Under the deal, IndusInd will exchange 639 of its shares for every 1,000 shares and that the deal would be all stock deal for both parties. All Stock deal has been preferred over open offer because liquidity of a bank like IndusInd Bank would not be compromised!

Synergies Between the IndusInd and BFIL

- The deal becomes accretive for IndusInd from first day because the margins will improve dramatically as the cost of funds will fall by 3 to 4%.
- BFIL already has a business correspondent relationship with IndusInd and they can cross-sell other products like micro insurance, savings etc.
- The risk weight will drop to 75% from 100% for IndusInd Bank as entire portfolio consists of the microfinance Loan, which comes under priority sector lending. The surplus capital can be deployed for more efficient / profitable ventures.
- As per Mr. Ramesh Sobti, CEO of IndusInd Bank, “there will not be any loss of jobs for 10,000 BFIL employees”.
- After the merger, it will have access to over 2.9 lakh centres of BFIL, largely in rural areas.
- For IndusInd Bank, the immediate benefit will be deeper penetration in rural areas. BFIL’s loan book amounting to Rs.10,971 Crore would be absorbed by IndusInd and all these loans will be treated as so –called ‘priority loans which Indian banks are required to adhere to the extent of 40 % of their loan book and the share of microloans on IndusInd’s book will rise from 3 % to 7 %.

Calling **Demonetization a Black Swan event** said it had only one time impact and BFIL has been recovering well. BFIL will be able to migrate its operations involving a little over 6 million rural borrowers to IndusInd Bank’s banking platform, thereby bringing down its business costs. The deal is essentially a shortcut exposure to a banking licence, which was denied earlier by RBI.

**FIGURE 1
MARKET IMPACT**



IndusInd Bank Limited - INDUSINDBK

20-Oct-2017 Friday

Pr Cl: 1690.85 Op: NaN Hi: NaN Lo: NaN Cl: NaN Vol: NaN Chng: Change

Click on chart to draw price Cross Hair

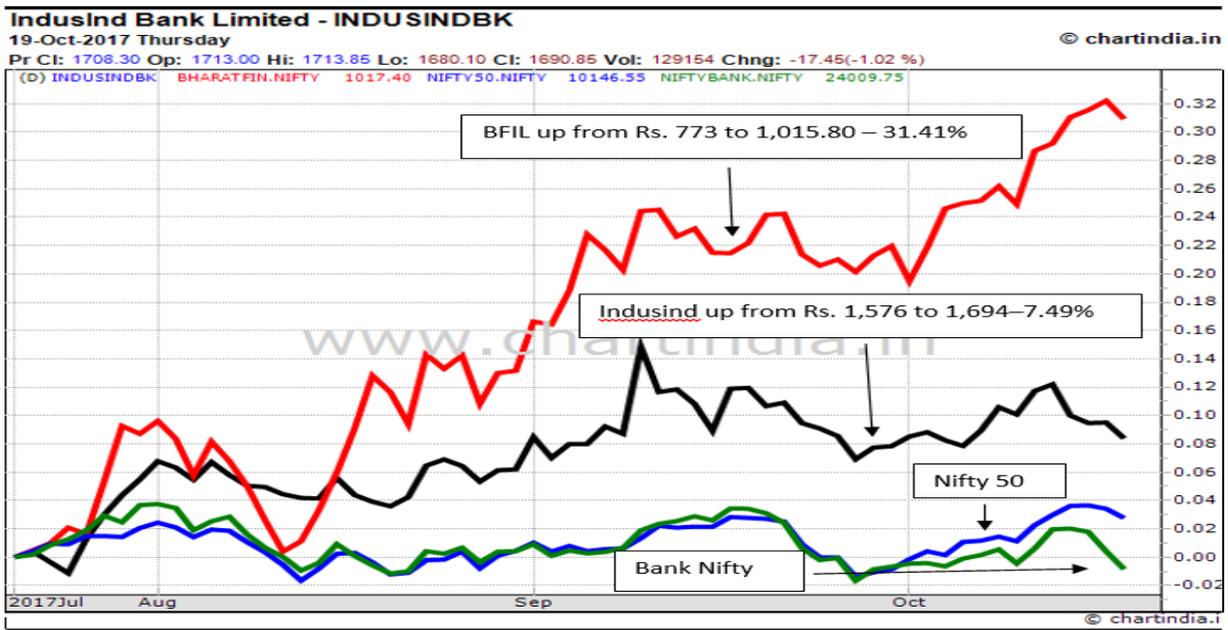
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Source-Chartindia.com

Shares of IndusInd Bank and Bharat Financial Inclusion were trading higher after the Board of Directors of respective companies signed agreement for exploring merger. BFIL was trading nearly 4% higher at Rs 967 on BSE. Similarly, IndusInd was trading at Rs 1,791 which was nearly 5% higher than last closing. Post-merger, IndusInd lost nearly 2% and closed at Rs 1716 whereas BFIL gained 1.56%. The market felt that IndusInd paid higher premium for the acquisition.

**FIGURE 2
POST MERGER MARKET IMPACT**



Source-Chartindia.com

On comparison, the NIFTY FIFTY was up nearly 4% (during the period 21st August-20th October 2017), whereas IndusInd gained by nearly 5% and BFIL rose by 18.5% subsequent to announcement of swap ratio of 0.639 shares of IndusInd bank against 1 share of BFIL.

CONCLUSION: EMERGING ISSUES

- ❖ For every MFI, the ultimate destination is to become a bank. BFIL had applied for the small bank licence but did not get it. Since then, BFIL had been exploring various alternatives. Merger with IndusInd would help BFIL in realizing this objective and will benefit all stakeholders.
- ❖ BFIL's loans would be subsumed in IndusInd Bank's balance sheet but its distribution network will be housed in wholly owned subsidiary of the Bank. But how much of a liability franchise BFIL can benefit? Building a scalable deposit base is not a comfort zone for BFIL. Synergy between IndusInd and BFIL would help both.
- ❖ Consolidation for the banking sector would arise when private banks acquire MFIs and this acquisition of BFIL by IndusInd would enhance customer acquisition and deeper penetration in rural areas.

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APPENDIX: ABBREVIATIONS

BSE – Bombay Stock Exchange
FY - Financial Year
MFI – Micro Finance Institutions
NBFC – Non Banking Finance Corporation
NPA – Non Performing Assets