IDFC INSTITUTIONAL SECURITIES
India Research

Event update

ICICI Bank

Rs889

OUTPERFORMER

Merger with Bank of Rajasthan; share swap ratio of 25:118

Mkt Cap: Rs992bn; US$21.1bn

18 May 2010

BSE Sensex: 16876

Financials

Event:

ICICI bank has approved an in principle merger with Bank of Rajasthan (BoR). The bank has entered into agreement with certain shareholders of BoR consenting to the share swap ratio of 25:118 (25 shares of ICICI Bank for 118 shares of BoR), subject to necessary regulatory approvals. The Tayal group is a dominant shareholder in BoR the bank with a declared stake of ~28% as of Mar-10.

Bank of Rajasthan – a brief profile

- Bank of Rajasthan is an old private sector bank headquartered in Jaipur. Founded in 1943, the bank has a customer base of over 2m.
- The Tayal group is the dominant shareholder of the bank with a declared stake of ~28% (as of Mar-10). However as per SEBI, Tayals hold 55% stake in the bank as of December 2009. Mr Tayal is the representative of the dominant shareholder group on BoR's board of directors. The board also includes 13 non-executive independent directors out of which 4 directors have been appointed by Reserve Bank of India.
- BoR has a network of 463 branches, 29 offsite ATMs and 82 onsite ATMs covering 22 states and 2 Union territories across the country. Most of BoR branches are located in northern and western India and the bank has a strong hold in the state of Rajasthan with a network of 294 branches (~63 % of total branches).

Exhibit 1: Bank of Rajasthan – branch network

	Branches		Off-site ATM		Onsite ATM	
Category	2008	2009	2008	2009	2008	2009
Metropolitan	129	129	6	6	24	30
Urban	142	142	19	19	25	29
Semi-Urban	90	90	2	2	16	20
Rural	102	102	2	2	2	3
Total	**463**	**463**	**29**	**29**	**67**	**82**

- BoR had an asset base of Rs172.2bn with a loan book size of Rs77.8bn. Retail loans constitute ~10.8% of the total loan book. The bank had delivered net profit of Rs1.18bn in FY09 and booked a loss of Rs100m for 9mFY10. The bank has total deposits base of Rs151.9bn with a CASA ratio of 27.4%.

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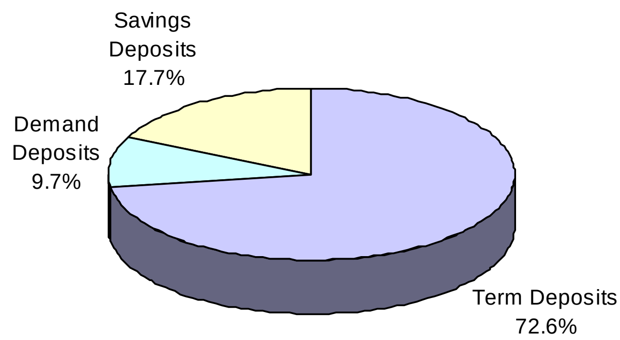
Exhibit 2: BoR - brief snapshot

	Mar-09
Advances (Rs m)	77,807
Deposits (Rs m)	151,871
CASA (%)	27.4
Branches (nos)	463
Total Assets (Rs m)	172,350
Networth (Rs m)	10,456
Calculated NIMs (%)	2.23
RoE(%)	11.80%
RoA(%)	0.71
Overal CAR(%)	11.5
Tier-I CAR(%)	6.19
Gross NPA(%)	2.04
Net NPA(%)	0.73



BoR – recent regulatory issues

- In Dec-09, declared stake of the Tayals stood at 28%, while as per SEBI Tayals' stake stood at 55%. Consequently, BoR had recently run into regulatory trouble as SEBI had banned the promoters and other entities of the controlling Tayal family from dealing in the securities market on account of incorrect disclosure of promoter's holding in the bank.
- RBI had also levied a fine of Rs2.5mn on the bank for alleged violation of various norms pertaining to transactions and misrepresentations of various documents. The regulator had then appointed Deloitte Haskins & Sells to conduct a special audit of the bank which has submitted its interim report.

What's in it for ICICI Bank?

ICICI Bank has announced swap ratio of 1:4.72 for certain shareholders for the bank. The ratio imputes a BoR's valuation at ~Rs30.4bn – 4.8x estimated book value as of Dec-10. We expect the merger to be value accretive for ICICI Bank in the medium term. With respect to balance sheet size, BoR is significantly smaller than ICICI Bank (of ~5%). Consequently, we do not expect material impact on asset profile of ICICI Bank. However, BoR's branch network at 463 branches stands at ~25% of ICICI Bank's current network. Access to this large, underutilized branch network with concentration in the CASA-rich northern region is a key positive for ICICI Bank. We see an opportunity for significant value creation as ICICI Bank leverages BoR's branch network by improving productivity levels (cost to income ratio at 62% for 9mFY10 against 37.6% for ICICI Bank for FY10).

On the other hand, given the widely-known issues regarding corporate governance at BoR, we await clarity on BoR's asset quality (Gross NPAs at 2.84% as of Q3FY10). However, we do not expect losses, if any, to be material in nature for ICICI Bank.

Access to a large branch network - ~25% of the present

- The merger of ICICI Bank and BoR will augment the network of the combined entity to ~2,463 (~25% increase in ICICI Bank's present branch network) further consolidating its position as largest private sector bank by branches.
- The access to such a large and wide branch network augurs well for ICICI Bank as it enters a growth phase in FY11.

Merger strengthens presence in northern region

- While BoR has pan-India presence, its network is significantly stronger in the northern states like Rajasthan, Punjab, Haryana and Delhi (~73% of total branches in these states). We expect the merger to strengthen ICICI Bank's presence in these areas.

Limited impact on asset profile

- BoR's balance sheet is significantly small with respect to ICICI Bank (~5% of total assets).
- Consequently, we see insignificant impact of this merger on overall advances profile of ICICI Bank.

Immense scope for productivity improvement with limited investments

- BoR has 463 branches, which is significant for the present balance sheet size of the bank. However, there is significant scope for improvement in utilization of the branch network, as branch/ employee productivity is still way below that for the peer group. We see huge opportunity for productivity improvement for BoR, which would be a medium term positive for ICICI Bank.
- Additionally, ICICI Bank and BoR have implemented the same software platforms, which we believe would enable smoother integration with limited investments in infrastructure.

BoR's asset quality

- BoR's asset quality has remained relatively healthy over 9mFY10 with Gross NPAs increasing by ~Rs714m in absolute terms (~0.9% of advances). We believe that this increase is a reflection of the phenomenon witnessed across the industry in the aftermath of the downturn and not specifically a reflection of bank's credit quality.
- Going forward, with revival in the economic environment, asset quality concerns are likely to recede.

Valuations and view

Given the regulatory hurdles, lack of access to growth capital (Tier-I at 6.19% as of Mar-09) had constrained BoR's growth trajectory in FY10 (~5% advances growth over 9mFY10) and had resulted into to an underleveraged franchise. The merger provides ICICI Bank a lucrative opportunity to eke out productivity gains and create value over the medium term.

Currently announced swap ratio imputes BoR's valuation at ~Rs30.4bn (4.8x book value as of Dec-10), translating into a per share price of ~Rs188.3 – a premium of ~89% over the CMP. An attempt to value the CASA franchise of BoR offers a plausible explanation for the valuations offered by ICICI Bank. Assuming a nominal growth in CASA deposits (in line with GDP growth), the interest gains made by ICICI Bank would result into a PV of ~Rs26-33bn, which amounts to over 85% of BoR's valuation. Moreover, we believe, creation of such a wide branch network (with a CASA/branch of ~Rs91m) would have consumed significant time and management bandwidth.

Exhibit 3: Valuing the CASA franchise of BoR

CASA deposits in Rs m (as of Mar-09)	41,630
Effective cost of CASA deposits (%)	2.5-3.0
Marginal cost of 1-yr deposits for ICICI Bank (%)	6.0-6.5
Interest spread (%)	3.5-4.0
Interest spread (Rs m)	1,457 - 1,665
Present value of perpetuity (Rs m)	**26,491 - 33,304**

While the merger is expected to be marginally earnings dilutive (by ~3%) in the near-term, we see a significant value creation opportunity over the medium-term as the bank leverages BoR's underutilized network of ~463 branches (~25% of ICICI Bank's present branches) in the northern and western regions of the country.

We remain convinced of ICICI Bank's medium term earnings trajectory and believe that the bank is now ready to execute the next phase of its strategy to deliver high profitability while accelerating balance sheet growth. We would revert with our revised earnings estimates for ICICI Bank as further clarity emerges on this front. Maintain Outperformer.

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