HDFC Bank jolts Indian market - IFR News

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MUMBAI, Jul 7 (IFR) - The US$40bn merger of **HDFC Bank** and mortgage lender Housing Development Finance Corporation, which became effective on July 1, is set to intensify competition and consolidation in India's financial sector, while forcing institutional investors to make adjustments to their portfolios.

The combination, first announced in April last year, creates a private sector giant that will control 13% of the country's bank assets, according to Fitch estimates, and rank among the world's top 10 banks by market capitalisation.

The new HDFC Bank has said it wants to double its balance sheet every four years, laying a challenge to state-owned State Bank of India, the current market leader with 23% of bank assets, and putting smaller lenders under notice that they will need to raise their game as well.

"[The] HDFC Bank and HDFC merger is bound to shake up the sector's competitive dynamics because it will widen the gap on market share and reach from its nearest competitors and narrow the gap from State Bank of India," said Saswata Guha, senior director and team lead for financial institutions at Fitch in India.

HDFC Bank is now well ahead of rivals ICICI Bank and Axis Bank, which have market shares ranging between 5% and 7%, according to Fitch.

"This significant gap will likely encourage banks to go back to their drawing boards, which could also involve exploring acquisitions as a potential recourse to bridge the gap," Guha said.

Consolidation under way

Consolidation is already under way. Three days after the completion of the HDFC merger, **IDFC Limited** announced it would merge with **IDFC First Bank** to simplify its corporate structure. Like HDFC Bank, which was created by HDFC in 1994, IDFC First Bank was born in 2015 as a spin-off of its non-banking parent IDFC

Earlier this year, Axis Bank completed the acquisition of Citigroup's domestic consumer and non-banking financial business in India. And, last month, ICICI Bank announced that it will take its majority-owned unit ICICI Securities private.

"Operating conditions are looking strong for the financial sector in India, to that extent, some of this is creating opportunities for the financial institutions to merge," said Alka Anbarasu, associate managing director at Moody's. "Capital markets are buoyant and Indian bank valuations have improved giving them options for doing acquisitions, at a time when credit growth is hitting mid-teen levels in FY24 from being extremely low, in single digits, in the past decade as the corporate capex cycle is also improving."

According to the Reserve Bank of India's annual financial stability report released last month, the common equity Tier 1 ratio of Indian commercial banks was at a record 13.9% at the end of March, while their gross non-performing assets fell to a 10-year low of 3.9%.

"Consolidation or any form of transactions/acquisitions in the financial sector are going to be opportunistic where they fit with the credit profile of the institution," Anbarasu said.

The retail lending segment is where the action is likely to take place, according to Anbarasu. At a time when steady economic growth of around 6% per year is making Indians more affluent and loan advances are growing in double digits, banks want to boost their retail lending book. This makes the assets of non-banking financial institutions and microfinance lenders very attractive to banks, Anbarasu said.

The merger will significantly enhance HDFC Bank's product portfolio by giving it a higher percentage of secured and long duration mortgage loans. "The merger will also improve the bank's ability to cross-sell retail banking products to the customers of HDFC Limited," said Rebecca Tan, a senior analyst at Moody's.

Portfolio adjustments

As well as altering the competitive landscape, the HDFC Bank merger will have an impact on investors holding the outstanding securities issued by the two original entities.

On the equity side, HDFC shareholders will receive 42 shares of HDFC Bank for every 25 shares on July 13.

Some local mutual funds will have to sell part of their holdings in HDFC Bank as they are not allowed to invest more than 10% of assets in a single company. This is not expected to have a major impact because the stock is very liquid, allowing funds to sell steadily into the market without having to launch blocks, and the heightened profile of the merged entity is likely to attract a new set of foreign buyers.

"There will be a lot of interest from foreign portfolio investors and other investors given the strong long-term potential of the company, which shall act as a counterbalancing force," said Pranav Haldea, managing director of data provider Prime Database.

The implications are more complex for fixed income, as the specific rules that governed holdings of HDFC securities as a non-financial banking company no longer apply now that it is part of a bank.

This means that the bank borrowings of approximately Rs1.6trn (US$19bn) that HDFC had at the end of June have to be reclassified from July 1 as the exposure has shifted to HDFC Bank, rating agency Care said in a note. The exposure of the banking sector to NBFCs may temporarily decline as a result, but this will free up limits for other NBFCs to access bank funding.

The same dynamic will play out in the bond market, where HDFC was a major issuer. The mortgage lender had been on a fundraising spree to beef up its resources prior to the merger. It raised Rs784bn from the bond market in the financial year that ended in March and another Rs461bn since then, bringing its total bonds outstanding to Rs2.6trn, according to Prime Database.

HDFC Bank has Rs665bn of rupee bonds outstanding, but it has also tapped the offshore market. It raised US$750m from a three-year bond in February and US$1bn from an AT1 issue in August 2021.

"In the bond market, the huge space being vacated by HDFC presents a significant opportunity for other housing companies and NBFCs to tap the market and gain access to a whole new set of potential investors," said Haldea at Prime Database.

But some fund managers feel there are limited options to replace HDFC.

“Mutual funds will have more appetite for investing in debt papers of housing finance companies. However, finding another housing finance company that can match the size and credit quality of HDFC will be challenging," said Amandeep Chopra, group president and head of fixed income at UTI Mutual Fund.

Given the sheer size of HDFC's outstanding bonds, the Securities and Exchange Board of India has essentially waived the 10% limit for investment in the debt of a single issuer and said that mutual funds breaching the limit would be allowed to hold the investment until maturity.

Meanwhile, insurance companies are awaiting clarity from their own regulator on the appropriate classification of HDFC bonds. These have until now come under the housing and infrastructure segment, which has a minimum investment requirement of 15% of assets, so that insurers were free to buy as many HDFC bonds as they liked. By contrast, there is a maximum exposure requirement of 30% for BFSI (banking, financial services, and insurance) bonds, which could trigger selling unless the regulator gives a dispensation.

"The bonds of HDFC Ltd have faced selling pressure due to the merger. Some insurance companies may choose to sell to re-align their portfolios to meet the permissible limit, while others may approach the regulator to seek forbearance until the bonds mature," said Aneesh Srivastava, executive director and chief investment officer at Star Health and Allied Insurance.

The yields on HDFC's 7.8% June 2025 and 7.7% November 2025 bonds have risen by around 10bp to 7.91% and 7.83% respectively since early June, according to Refinitiv data.

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