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IDFC Bank and Capital First – A Case of Merger Arbitrage

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Six months into his dream job at Capitell Mr. Anand Agarwal, a recent MBA graduate from one of the top business schools in South India is contemplating on the pitch he has prepared to his boss. As Anand is taking a long walk on the late hours on Sunday, 14th January on Marine drive with the ocean to his left, his thoughts are preoccupied at the report he has prepared.

Capitell Inc. and the paradigm shift

Capitell Pvt. Ltd. is a category III - Alternative Investment Funds (AIFs) registered with SEBI whose main business ploy is profiting through long-short equity, and volatility arbitrage. Volatility Arbitrage involves maintaining delta neutral portfolios to take advantage of differences between the implied volatility of the option, and future realized volatility of the option's underlying. Traditionally, its parent firm Capitell Inc. a hedge fund with AUM of 11.4 billion USD focuses on inefficiencies in US and emerging equity markets. Capitell Inc. has returned 14.76% net of fees in 2017 better than the average return (8.5%) produced by hedge funds[1]. Sustainability in this industry is a direct function of an organization's propensity to adapt to dynamic changes in capital markets. In that regard, Capitell Inc.'s board recently voted in favor of a paradigm shift where Capitell, apart from existing strategies, also slowly focus on '*event driven*' arbitrage[2]. Mr. Richard Holmes, a successful wall street fund manager has been roped in specifically for this, and his main task to set up and build event-based arbitrage strategies. Richard's first recruit in this division is Anand, who has been tasked with identifying potential arbitrage opportunities.

IDFC's press release – An Opportunity?

While browsing through www.moneycontrol.com on the 10th of January, 2018, Anand spotted a particular news item titled *"IDFC Bank, Capital First explore merger: Talks at initial stage; deal will help bank tap into 5 million retail & SME customers of latter"*. Having read this news item, Anand decides this is the chance to kick start his firm's new philosophy of event-based arbitrage. On the next day i.e. 11th January 2018 (Thursday), the company secretary of IDFC Bank Ltd. Mr. Mahendra N. Shah wrote a letter of clarification to the National Stock Exchange of India (NSE) Ltd. providing clarification on this news item that had been in circulation the day before. IDFC Bank neither accepted nor denounced the news item in the press release. The neutral tone of the press release immediately became of importance to Anand, because this potentially provided him with an opportunity to strategize what his firm was looking for. Anand believed that should the reported rumors of IDFC Bank-Capital First merger was happening, Capitell had a chance to profit on this potential event (in this case Merger). As Anand read the letter again on 11th January 2018, he had made up his mind on his next course of action.

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[1]See Hedge funds produce best returns in 4 years (https://www.forbes.com/sites/nathanvardi/2018/04/17/the-25-highest-earning-hedge-fund-managers-and-traders-3/#30de45b53596

[2] Event driven arbitrages are arbitrage opportunities that arise due to unanticipated events (like potential merger announcements).

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