# HDBANK (HDB) – COMPANY NOTE
# WHAT DOES THE MERGER WITH PGBANK ENTAIL?

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**Key statistics**

| | |
|---|---|
| Current price (VND) | 42,000 |
| 52w range (VND) | 39,600 - 51,800 |
| Average daily turnover (3m) | 145,668m |
| Market cap (VND) billion | 41,202 |
| Outstanding shares (m) | 981 |
| Free float (%) | 61 |
| Trailing P/E | 18.4x |
| Current P/B | 2.8x |

**Ownership**

| | |
|---|---|
| Sovico JSC | 13.34% |
| Mr. Pham Van Dau - CFO | 4.30% |
| Ms. Nguyen Thi Phuong Thao | 3.67% |
| Others | 78.69% |

*Source: VNDIRECT*

**HDB's merger with PGBank will be beneficial long-term but is EPS dilutive in the near-term, potentially weighing on HDB's share price.**

**On the 21st of Apr 2018, HDB and PGBank agreed to merge; the merger still requires the SBV's approval to go through.** HDB and PGBank agreed on a merger whereby PGBank shareholders will receive 0.621 shares of HDB for each PGBank share owned. In order to execute the share swap, HDB will issue a total of 300m new shares, of which 186.3m shares will be distributed to PGBank shareholders under the above swap, and the remaining 113.7m shares will be offered to HDB shareholders through a 1:0.116 rights issue at an exercise price of VND 10,000/share. All of the 113.7m shares distributed to HDB shareholders will be repurchased by the merged entity as treasury shares at VND13,000/share. After the merger, HDB's charter capital will increase from VND9,810bn to VND12,810bn (+30.6%). The shareholders of both banks approved the merger but HDB will need to seek approval from the State Bank of Vietnam (SBV). HDB aims to complete the merger in August 2018. (Refer to page 3 for the detailed transaction structure).

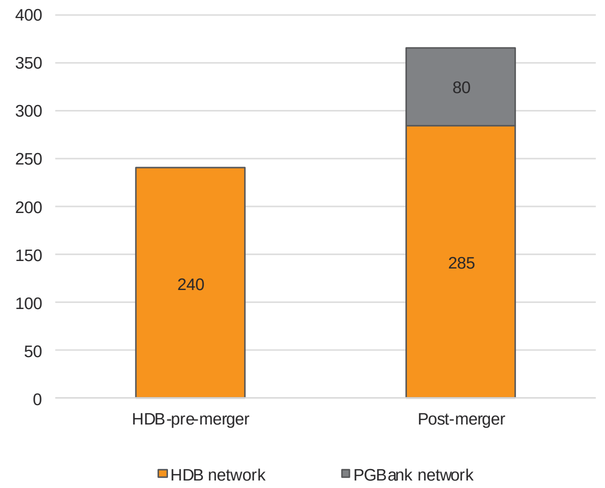
**The merger will allow HDB to rapidly expand its network.** After the merger, HDB's network will increase from 240 to 365 branches/transaction offices. This is a quick and cost-effective way for HDB to expand its network, as it can utilize PGBank's sizeable branch network rather than opening new branches. The merger will catapult the bank to the 2nd ranked among private banks in terms of its network, from 5th position currently, surpassing other large retail banks such as ACB and Techcombank.

**HDB will be able to benefit from PGBank's close relationship with Petrolimex...** Petrolimex currently owns 40% of PGBank but it needs to divest from PGBank as per new regulations requiring state-owned enterprises (SOEs) to divest non-core businesses. Petrolimex's ownership in HD Bank will be reduced to 5.82% post-merger. However, we believe that Petrolimex will maintain a close relationship with the merged bank as Petrolimex and HDB recently signed a strategic cooperation agreement.

**… by tapping into Petrolimex's vast network of 2,500 retail points and 4,000 agencies and 20m-strong customer base, post-merger.** As the nation's largest petroleum product distributor, Petrolimex has a vast network, customer base and employee headcount. Through the merger, HDB can target Petrolimex's customers, agencies, affiliated companies and employees. This large potential customer base is particularly valuable to HDB as the bank is focusing on retail and SME banking.

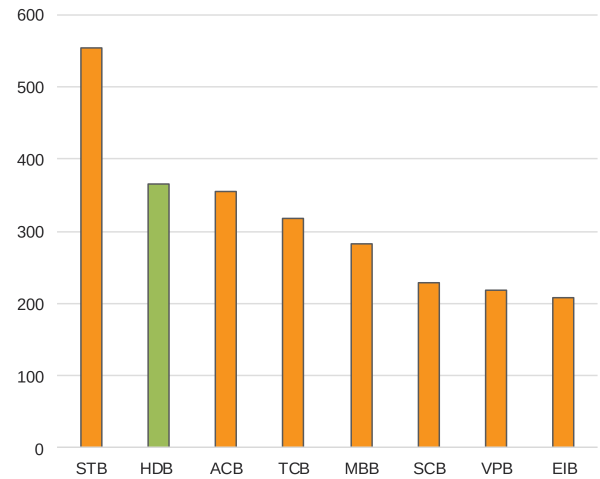
**The merger will also enable HDB to lower its funding costs.** PGBank provides cash management services and cash collection services for Petrolimex for more than 2,100 gas stations nationwide. As a result, its CASA rate (demand deposit/total deposit) is high by industry standards. As of FY17-end, PGBank's CASA was 24.3%, while HDB's CASA was relatively low at 12.9%. Based on FY17 financial results, the merger could improve HDB's CASA from 12.9% to 14.7%, thereby reducing funding costs for HDB.

**Figure 1: HDB's branch/transaction office network will expand by nearly 50% post-merger**




Source: Company, VNDIRECT

**Figure 2: The combined entity will have the 2nd largest network among private sector banks**



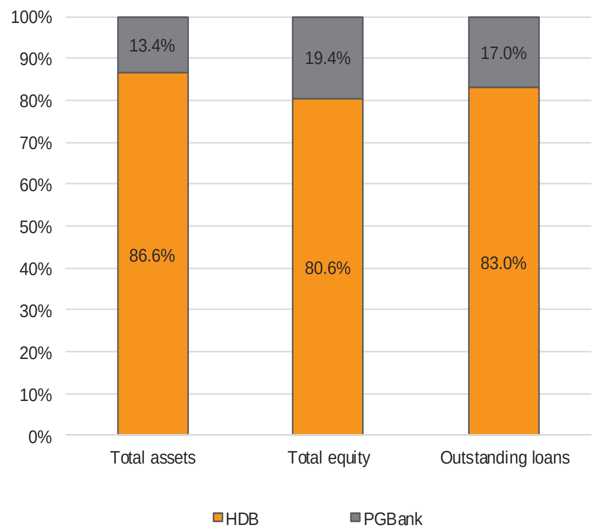

Source: Company, VNDIRECT

**PGBank's asset quality is inferior to that of HDB.** PGBank is a small bank with one of the smallest total asset bases in the banking sector. The bank had asset quality issues in the past with its NPL ratio rising to 8.4% in 2012, while its ROE was only 8.3%. During the past few years, the bank has slowed the pace of credit growth and has instead focused more on bad debt management and provisioning. Its NPL ratio was reduced to 3.3% in FY17 by using loan write-offs and debt sales to VAMC, but the level of stressed assets was still high as total NPLs and VAMC bonds amounted to 13.7% of total outstanding loans. ROE declined to 1.8% in FY2017 due to the provision burden for legacy bad debts.

**The merger will increase HDB's bad debt book, but within manageable limits.** PGBank is small relative to HDB, and post-merger, PGBank will contribute 13.4%, 19.4% and 17.0% to the combined entity's assets, equity and loan book, respectively. HDB's NPL and VAMC bonds reached 3.3% of its outstanding loans as of FY17-end. This ratio will increase to 5.1% if the merger goes through. However, both banks have booked provisions for VAMC bonds in the past few years, thus the ratio of NPLs and un-provisioned VAMC bonds of the merged bank will be 3.7%. This is a relatively high level of bad debt compared to other listed banks. HDB also has high bad debt itself due to problem loans incurred in the past (VAMC bonds account for 54% of total stressed assets). We still think that the bad debt at the merged bank will be at manageable levels and that HDB will have the financial ability to resolve its bad debt, given the bank's favorable growth outlook on the back of a significantly enlarged customer base post-merger.

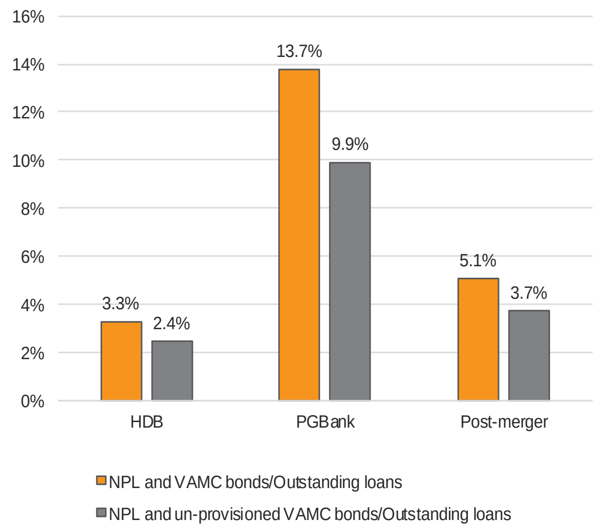
**There is a risk of rising NPLs, and thus, higher credit cost.** PGBank's NPLs have increased sharply from 2.5% of the loan book in FY16 to 3.3% of the loan book in FY17 and its group 2 loans also increased from 1.3% of total loans in FY16 to 2.4% in FY17. Due to the surge in NPLs, the loan-loss-coverage ratio (LLR) at PGBank was only 31.9% as of FY17-end. If there is a merger, HDB's LLR of 73.3% as of FY17-end will be dragged down to 60.4%. Given the increasing NPLs and the low provisioning buffer at PGBank, we expect that credit costs will increase post-merger to improve the provision coverage and also to facilitate a more aggressive write-off policy.

**Figure 3: Contribution of PGBank and HDB to the merged bank**




Source: Company, VNDIRECT

**Figure 4: The merger will increase HDB's NPL ratio**




Source: Company, VNDIRECT

**The merger will be beneficial for HDB, overall.** We believe HDB has the financial resources to resolve the new bad debt taken on from PGBank, post-merger. HDB posted 111% pre-tax profit growth in FY17 and the bank can achieve high profit growth in the coming years thanks to the expansion of retail lending at the parent bank and the strong growth of its consumer finance subsidiary. The merger with PGBank will provide HDB with a large network and valuable access to Petrolimex's customer base which is currently being underexploited by PGBank. These benefits will translated into clear competitive advantages for HDB in the retail and SME banking race, as the competition in this area continues to heat up.

## PROPOSED TRANSACTION STRUCTURE

HDB will issue a total of 300m shares and after the merger, the charter capital of HDB will increase from VND9,810bn to VND12,810bn. Below is the breakdown of the combined entity's charter capital:

- HDB's charter capital as of 31 Dec 2017: VND9,810bn (1)
- PGBank's charter capital as of 31 Dec 2017: VND3,000bn (2)
- Charter capital of the combined entity = (1) + (2) = VND12,810bn

In order to increase its charter capital to VND12,810bn (equivalent to 1,281m shares), HDB needs to issue 300m new shares which is equal to the current number of PGBank shares outstanding. Based on these 300m PGBank shares outstanding and the swap ratio of 1:0.621, PGBank shareholders will receive 186.3m shares of the 300m shares issued by HDB. The remaining 113.7m shares will be offered to HDB shareholders through a rights issue. The detailed plan and allied conditions are summarized below:

a) HDB shares distributed to PGBank shareholders:

- 186.3m shares will be distributed to PGBank shareholders; each PGBank share will receive 0.621 shares of HDB for every PGBank share owned.
- Lock-up on the swapped shares: 30% of the swapped shares can only be transferred starting six months after the merger. The remaining 70% can only be transferred starting 12 months after the merger.

b) HDB shares distributed to HDB shareholders:

- 113.7m shares will be distributed as a rights issue to HDB shareholders at an exercise price of VND10,000/share. Each HDB share will carry the right to buy 0.116 HDB shares.
- The rights cannot be transferred. In case HDB shareholders do not subscribe to the rights issue, HDB's Board of Directors (BOD) will distribute the rights to other investors.
- The new shares distributed to HDB shareholders cannot be transferred. Shareholders can only sell these shares to HDB.
- HDB will buy back all of these shares at a price of VND13,000/share, within 30 days from the share issuance.
- After the buy-back, HDB will lock its FOL and will sell treasury shares to foreign investors when it needs to raise capital.

**Figure 5: Summary of transaction structure**

| | | Charter capital (VND bn) | Shares outstanding (mn shares) | EPS (VND/share) |
|---|---|---|---|---|
| Pre-merger | HDB | 9,810 | 981.0 | |
| | PGBank | 3,000 | 300.0 | |
| | **HDB's FY17 EPS** | | | **1,871** |
| Merger | Total new shares issued | | 300.0 | |
| | *Shares distributed to PGBank shareholders* | | *186.3* | |
| | *Shares distributed to HDB shareholders* | | *113.7* | |
| Post-merger | HDB-PGBank (combined entity) | 12,810 | 1,281.0 | |
| | **FY17 EPS - (21.6% dilution versus pre-merger EPS)** | | | **1,468** |
| Post-merger and after shares buyback | Share buyback | | (113.7) | |
| | HDB-PGBank (combined entity) | 12,810 | 1,167.3 | |
| | **FY17 EPS - (13.6% dilution versus pre-merger EPS)** | | | **1,617** |

Source: Company, VNDIRECT

**The swap ratio and the 30 day-average share price of HDB imply that PGBank is being valued at VND8,900bn (US$392m)**, equivalent to 2.5x of PGBank's FY17 book value. After the transaction, EPS will be diluted by 13.6% due to the aforementioned new share issuance, however, HDB shareholders are being compensated with a gain of VND3,000 per new share purchased through the rights issue as the bank will issue rights at VND10,000/share and buy back these shares at VND13,000/share. Although the merger is likely to generate long-term synergies by plugging HDB's strong retail-lending and consumer finance capabilities and products into PG Bank's and Petrolimex's network, the immediate EPS dilution could warrant a fall in the share price.

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| **Score Range:** | 90 - 100 | 80 – 89 | 70 - 79 | Below 70 or | No Survey Result |
|---|---|---|---|---|---|
| **Description:** | Excellent | Very Good | Good | N/A | |

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## RECOMMENDATION FRAMEWORK

| **Stock Ratings** | Definition: |
|---|---|
| Add | The stock's total return is expected to reach 15% or higher over the next 12 months. |
| Hold | The stock's total return is expected to be between negative 10% and positive 15% over the next 12 months. |
| Reduce | The stock's total return is expected to fall below negative 10% over the next 12 months. |

*The total expected return of a stock is defined as the sum of the:(i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.*

| **Sector Ratings** | Definition: |
|---|---|
| Overweight | An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation. |
| Neutral | A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation. |
| Underweight | An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation. |

| **Country Ratings** | Definition: |
|---|---|
| Overweight | An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark. |
| Neutral | A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark. |
| Underweight | An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark. |

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