NSE Indices Ltd is planning to change the methodology of merger and demerger of index constituents for equity indices to avoid big churnings, which happens in the current system. This comes ahead of the proposed merger of HDFC with HDFC Bank. The proposal, if considered, is expected to avoid sharp movement in stock prices of firms that are in the process of merger or demerger. In its consultation paper, NSE Indices has suggested to make ex-date an important factor for replacing an index constituent. It has sought comments from market participants on the proposed revision in the treatment of merger and demerger of index constituents for equity indices till 2 Nov. With regards to the treatment of a merger, NSE Indices has proposed that the transferor company will be excluded from the index on the ex-date (T-1 day) of the merger—the closing of the T-1 day merged entity.

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NEW DELHI: NSE Indices Ltd, a subsidiary of National Stock Exchange, is planning to change the methodology of merger and demerger of index constituents for equity indices to avoid big churnings, which happens in the current system. This comes ahead of the proposed merger of HDFC with HDFC Bank. The proposal, if considered, is expected to avoid sharp movement in stock prices of firms that are in the process of merger or demerger.

In its consultation paper, NSE Indices has suggested to make ex-date an important factor for replacing an index constituent. It has sought comments from market participants on the proposed revision in the treatment of merger and demerger of index constituents for equity indices till 2 November. With regards to the treatment of a merger, NSE Indices has proposed that the transferor company will be excluded from the index on the ex-date (T Day) of the merger—the closing of the T-1 day merged entity.

Equity shares, investible weight factor and capping factor of the merged entity would be updated based on the terms of a merger on the ex-date of the merger.

On ex-date, a replacement of company will be made based on the eligibility criteria of respective indices in place of the transferor company, which is being excluded from indices with a fixed number of constituents, as per the proposal issued late night on Tuesday.

Indices with a variable number of constituents, NSE indices suggested that no replacement will be made in place of the transferor company which is being excluded.

The announcement of these changes would be made a minimum of three working days in advance for the change in the constituents of indices, including the indices on which Futures and Options are traded at NSE.

At present, shareholders' approval for the scheme of arrangement for a merger of a company is considered a trigger for making the index reconstruction and weight rebalancing and soon after the shareholders' approval, exclusion of the transferor company is initiated from the respective indices.
NSE Indices floats consultation paper on index rules

NSE Indices, a subsidiary of National Stock Exchange, is planning to change the methodology of merger and demerger of index constituents for equity indices to avoid big churnings, which happens in the current system. The proposal, if considered, is expected to avoid sharp movement in stock prices of firms that are in the process of merger or demerger.
NSE Indices Ltd has proposed a revision in the treatment of mergers and demergers of index constituents for Nifty equity indices. Therefore, it has initiated consultation and sought feedback on the manner of reconstitution of indices by November 2.

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HDFC Bank and HDFC Limited are likely to be among the first stocks to undergo the new process if the proposal is approved and implemented.

Following the announcement on Tuesday evening, HDFC and HDFC Bank shares rallied 2.5 percent and 1.6 percent, respectively, on Wednesday.

What happens currently when two or more firms merge/demerge
At present, right after shareholders give a nod to the merger, the stock of the merging company is excluded from indices and replaced with new stock.

Shareholders’ approval is considered a trigger to initiate the replacement of such a stock. As a result, the exclusion of the stock is done much ahead of its ex-date of merger/demerger.

“More specifically, in case of event-based reconstitution on account of merger, index reconstitution takes place at the time of exclusion of the transferor company and subsequently weight rebalancing of the stocks in the index takes place when the shareholders of the transferor company are allotted shares of the merged entity and they are available for trading at NSE (in case the merged entity is a constituent of the same index),” according to the NSE Indices circular.

This results in the churning of stocks twice in case passive funds (ETF/Index funds) are tracking such index.

What changes
If the NSE proposal goes through, it states that the stock of the merging company (for instance, HDFC) will be removed but not after shareholders’ approval but only on ex-date. This will lead to passive holders automatically holding HDFC Bank as their name will come on record.

The investible weight factor and capping factor (if applicable) of equity shares of the merged entity shall be updated based on the terms of the merger on the ex-date of the merger.

The exchange will also announce the new company to be included in the index on ex-date.

As per the proposal, in case of indices with fixed number of constituents, a replacement of company will be made on ex-date, based on the eligibility criteria of respective indices in place of a transferor company being excluded.

In the case of indices with a variable number of constituents, no replacement will be made on the ex-date in place of the transferor company which is being excluded.

Why has NSE proposed the change

The key rationale behind the move is that it would address longer exclusion and multiple adjustments to indices, especially given the rise of exchange-traded funds (ETFs) and index funds.

Nuvama Alternative and Quantitative Research believes that it is now unlikely HDFC gets excluded from Nifty, which would have meant an estimated outflow of $1.5 billion.

“If these proposed changes are considered after the consultation is over, then HDFC Ltd will only get excluded on the ex-date (which will likely be Q1FY24). This is the standard practice followed globally,” the experts at Nuvama cited by Moneycontrol said.
The new proposal by NSE Indices is essentially meant to curb the market volatility arising out of the HDFC-HDFC Bank merger. With HDFC being a part of the Nifty indices, the scrip could witness massive selling from passive funds. If the proposal is approved and implemented then HDFC Bank and HDFC are likely to be among the first stocks to undergo the new process.

The key rationale behind National Stock Exchange subsidiary NSE Indices’ proposal to revise the treatment of merger and demerger of index constituents its metrics is to stem the volatility in stocks that arises out of the event-led announcement and consequent rebalancing.

If the proposal is approved and implemented, HDFC Bank and Housing Development Finance Corporation (HDFC) are likely to be among the first stocks to fall under the new rubric.

The HDFC-HDFC Bank merger will likely create the third-largest Indian company as measured by market capitalisation. With HDFC being a part of the Nifty indices, the mortgage company’s scrip could witness massive selling from passive funds, market experts believe. A report from international financial services firm Investec pegged these outflows at $2.4 billion by way of 88 million shares from exchange-traded funds and index funds tracking the underlying indices as of December 2022. Emkay Global Financial Services estimated an outflow of $1.25 billion.

If the proposal by NSE Indices is approved, sharp swings could be avoided in the prices of shares of companies that are in the process of being included or excluded from the indices on account of buying and selling by passive funds that track these indices.

NSE Indices has proposed changes for the inclusion or exclusion of a company from or into the indices closer to the event.

The NSE arm is seeking feedback from the market regarding the methodology.

Punit Patni, an equity research analyst at Swastika Investmart, a financial services firm, believes a change in the methodology of merger and demerger of index constituents will prevent needless churn in the index and funds tracking such index.

“This move will be beneficial for HDFC and HDFC Bank shareholders, as the current expected $1.5 billion outflow in HDFC due to index rebalancing would have caused unnecessary loss for investors and traders at least in the short term,” Patni pointed out.

But Koushik Mohan, lead analyst at Ashika Institutional Equities, feels that this proposal “might not bring a revolutionary change”. His reasoning is that this would largely affect arbitrage fund managers who take advantage of special events like mergers and demergers but overall, except averting wild fluctuations in the stock price of the companies concerned, this proposal is unlikely to create any difference.

Nuvama Alternative & Quantitative Research said if the proposed changes are considered after the consultation is over, HDFC will only get excluded on the ex-date which will likely be Q1 of FY24.
Mumbai: The National Stock Exchange (NSE) plans to change the methodology of the Nifty and other indices’ constitution, which could help the amalgamated HDFC Bank retain the weightage the merging companies currently enjoy throughout the process.

Without this change, passive funds that invest in Nifty and indices that have the two companies could see disruption as, under current norms, the NSE drops out the merging entity’s scrip within a month of shareholders approving the merger.

Market persons said a change is required as the HDFC twins have a 30% weightage in the financial services index and significant weightage in all other indices. NSE’s proposed changes come in the form of a consultative paper. In the paper, NSE has said that the current methodology poses challenges when both the merging companies are part of the index (which is the case with the HDFC twins).

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Under the current methodology, in such cases, the index is reconstituted twice. First, when the merging company is excluded and second, when the shareholders of the transferor company are allotted shares of the merged entity.

The index issue has been weighing over the HDFC Bank scrip which has underperformed despite a 20% jump in net profit and clearances for the merger coming sooner than expected. Reports of HDFC’s early exclusion from the index caused investors’ uncertainty.

The merger, announced in April this year, has already received in-principle approval from regulators and the green signal from the stock exchanges. Last week, the National Company Law Tribunal (NCLT) had given approval for holding a shareholder meeting.

“According to the management, there is a possibility that the merger could consummate a quarter earlier than September 2023, which they had guided earlier. They have asked for exemptions for the RBI for priority sector, statutory requirements, stake increase in insurance subsidiaries for which clarity is still awaited, but they are in continuous dialogue with the RBI,” said Macquarie Capital head (financials research) Suresh Ganapathy.