Chapter 1 Introduction
1: Introduction

1.1 Overview

Mergers and acquisition (M&A) refer to actions involving takeovers, corporate restructuring, corporate control as well as alterations in the ownership pattern of any firm in an industry. Merger of two or more organizations or firms into one or the acquisition of one big organization by another is a very popular strategic exercise, which has gained popularity among organizations in most developed countries around the world.

Merger is defined as “Any combination of two or more firms with the larger being considered the acquirer” (Gaughan, 2005). However, the acquisition refers to “the act of one corporation acquiring a controlling interest in another corporation: this can be in an unfriendly hostile takeover or through a friendly merger. The buying corporation may offer incentives to stockholders such as offering a price well above the current market value.” (Gaughan 2005)

However, in literature there is no clear difference between mergers and acquisitions as the impact of the two activities is quite similar (Green and Cromley, 1982; Gaughan 2005).
1.2 Overview of History of Indian Banking

The Indian banking sector has seen tremendous transformation from its origin till date. The early stage i.e. first stage from 1780-1970, wherein several local banks were set up. In stage second i.e. from 1970-1991, the policies mainly stressed on nationalization, regularization and growth of Indian banking sector. In the next stage i.e. after 1991 which witnessed the liberalization of banking sector where many private sector banks came to picture in Indian scenario.

With the reforms post liberalization, the Indian banking sector, is standing on a cross road wherein on one hand due to various policies and initiatives by the R.B.I and the government (e.g. amendments to the Banking Regulation Act) the banks are better off in terms of product spree, outreach and are having sound asset quality. The substantial increase in requirement for retail loans has been a key driver for high growth in the banking sector. Along with that increased outreach in semi urban areas though automated teller machines and debit-cards and increase in the asset quality of the banks due to better risk management practices like securitization, diversification, swaps and spreads with the use of modern technology have been the main contributors to the phased success.

Further, the key concern is the increase in cost of operation especially for small banks with the implementation of latest regulatory norms in terms of Basel II and III which require banks to maintain additional resources as a cushion for tackling
crisis type situations. The latest regulatory norms in regards to banking sector are introduction of Basel III. The third of the Basel Accords was developed in a response to the deficiencies in financial regulation revealed by the global financial crisis. Basel III strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage. The OECD estimates that the implementation of Basel III will decrease annual GDP growth by 0.05 to 0.15 percentage point.

Basel III proposes many newer capital, leverage and liquidity standards to strengthen the regulation, supervision and risk management of the banking sector. The capital standards and new capital buffers will require banks to hold more capital and higher quality of capital than under current Basel II rules. The new leverage and liquidity ratios introduce a non-risk based measure to supplement the risk-based minimum capital requirements and measures to ensure that adequate funding is maintained in case of crisis.

Mergers and Acquisitions have been used widely to reshape and restructure business organizations and firms. In India, the concept of mergers and acquisitions was initiated by the government bodies. M&As played an vital role in transformation of the Indian industrial sector since the Second World War period. The economic and political conditions during the Second World War and post-war periods (including several years after independence) gave rise to a spate of M&As. The inflationary situation during the wartime enabled many Indian businessmen to amass income by way of high profits and dividends and black
money (Kothari 1967). This led to wholesale infiltration of businessmen in industry during war period giving rise to hectic activity in stock exchanges. There was a craze to acquire control over industrial units in spite of swollen prices of shares. The practice of cornering shares in the open market and trafficking of managing agency rights with a view to acquiring control over the management of established and reputed companies had come prominently to light. The net effect of these two practices, viz of acquiring control over ownership of companies and of acquiring control over managing agencies, was that large number of concerns passed into the hands of prominent industrial houses of the country (Kothari, 1967).

The reform process initiated in India after 1991 created room for opportunities and challenges both in the domestic and international spheres. The increased competition in the global market has prompted the Indian companies to go for mergers and acquisitions as an important strategic choice. The trends of mergers and acquisitions in India have changed over the years. The immediate effects of the mergers and acquisitions have also been diverse across the various sectors of the Indian economy.

A cursory listing of headline-grabbing mergers in the post-liberalization era shows that the trend began with the merger of Reliance Petrochemicals Ltd with Reliance Industries Ltd (RIL) in 1992. This was followed by the three-way merger, again involving the Reliance group, of Reliance Polypropylene, Reliance Polyethylene and RIL in 1995. Then the mega-merger of Hindustan Lever Ltd (HLL) with Brooke Bond Lipton India Ltd (BBLIL) happened in 1996.
The Indian banking system too experienced drastic and comprehensive consolidation through the mergers and acquisitions (M&A) route, when government of India adopted the route of mergers among others with a view to restructure the banking system. Mergers and Acquisitions are considered to be the fast track for increasing the size, expanding branch network and enlarging business operations. Notable among which have been Grind lay Bank merged Standard Chartered Bank, Times Bank with HDFC Bank, Bank of Madura with ICICI Bank, Nedungadi Bank Ltd. with Punjab National Bank and most recently Global. ICICI Bank merger with Bank of Rajasthan (BoR), whose promoters are being pushed by the Reserve Bank of India (RBI) to offload their stake.

The Indian banking sector is expected to see a lot of activities involving Mergers and Acquisitions, with the sole objective of consolidation combating themselves from high competition. Both the public as well as private sector banks are trying to find opportunities of acquiring small or foreign banks. As an example, the State Bank of India, the largest bank of the country has major overseas acquisition plans in its bid to make itself one of the top three Banks in Asia by 2008, and among the top 20 globally over next few years. Some of the banks are even planning to merge with their peers like Dena Bank, UCO, Vijaya, Yes Bank to consolidate their capacities.

The experts of the area are expecting large cooperative banks to join hands with each other and frail and underperforming banks merging with large and stronger ones in future. As M&A’s provide banks with opportunities of better outreach and
benefits of economies of scale, such mergers between weak/unviable banks should be encouraged which may act as remedy for weaker banks in providing continuity of employment to its human resource and adding constructively to the success of the nation.

To assess whether mergers work, it is necessary to examine the motives and reasons underlying the move before evaluating the results. First question: why do companies seek to merge? There are several theories which try to explain this phenomenon. The most popular among them is that M&As are the fastest route to growth. That growth is vital for a firm’s survival is indisputable (Traditional economic theory). Corporate finance theory holds that growth and the value of the firm are related and all share valuation models factor growth into their analysis. Therefore, the main objective of the study is to examine whether mergers and acquisitions are able to create value additions and synergies leading to improvement in efficiency so that bank mergers and acquisitions (M&A) become the order of the day.

1.3 Research questions, objectives and contributions

Indian banking system has experienced drastic and comprehensive reforms for more than two decades. The reform has achieved phased success, while challenges remain. Apparently, there is a need for an in-depth and comprehensive study to gauge the pre merger and post merger performance of Indian banks. A number of research questions could be asked and this study focuses on questions arising from two main areas. The first area to be explored is the motives behind mergers in Indian banking system. The second area is to
examine the effects of mergers/consolidation on bank performance. Did the total factor productivity of Indian banks increased after the consolidation stage? Which banks have performed better and why? Does the mergers/acquisition strategies have positive impacts on bank efficiency? What short-term and long-term effects do these reform strategies have? What effects did these mergers/consolidation had on the share prices of these banks i.e. whether the mergers leads to abnormal returns in shares and the affect of volatility in their prices?

1.4 Research Methodology

The study tries to ascertain the theoretical economic grounds or motives for mergers in banking sector in India. Secondly, it tries to assess the efficiency of consolidated banks over the past years, for which frontier analysis will be employed. Frontier analysis method distinguishes the best practice banks against which the relative performance of each bank is derived using a numerical efficiency score and ranking. Employing a stochastic frontier analysis approach, performance is measured by up-to-date efficiency estimates of technical efficiency, cost efficiency and profit efficiency. After obtaining efficiency scores using DEA, the study examines the impact of post mergers synergy on the company’s performance through –Banking Ratios-liquidity, risk-return, event study.

The study tries to ascertain the theoretical economic grounds or motives for mergers in banking sector in India with the help of secondary data drawn from publicly available data sources. The study is based on data of banks where
mergers and acquisitions took place, covering period of twelve years from 2000 to 2011. The data relating to bank performance and efficiency variables has been collected from PROWESS database. The study utilizes a range of measures like efficiency scores using DEA, impact of post mergers synergy on the company's performance through –Banking Ratios-liquidity, risk-return and event studies. The study also adopts the panel data framework for analyzing the relationship between Post/Pre merger cash flows and bank performance measures. Different specifications and estimation techniques have been employed to test the empirical analysis and robustness of the results. Since OLS estimator could yield biased and inconsistent results. Therefore, the study utilizes fixed Effects (FE) estimator, which can handle the issue of omitted variables. Further, abnormal returns in case of event studies have been estimated using OLS and GARCH Models. The robust and alternate measure used in this study ensures the precision of efficiency estimates, which in turn improves the reliability of findings and conclusions drawn from these estimates. By achieving these objectives, this study contributes to existing literature on bank efficiency from the perspective of developing and transition countries.

1.5 Need for the Study

From the review of literature it has been found that the study on mergers and acquisition is limited so far. Kaur (2002) in his study examined takeover of a sample of twenty companies during 1997-2000 using a set of eight financial ratios 3, and found both profitability and efficiency of targeted companies declined in post- takeover period, but the change in post-takeover performance
was statistically not significant. Beena (2004) also studied the pre and post-merger performance from a sample of 115 firms from the Indian manufacturing sector for a period of 6 years, between 1995-2000, using a set of financial ratios and failed to find any evidence of improvement in the financial position between pre and post merger period. Also, no significant study has been found on analysis of mergers motives and post merger synergies in India especially in the banking sector.

So far the research has been aimed in the areas of impact of mergers and acquisitions on corporate performance using total factor productivity measures in industry. But in this study this will be accomplished by measuring improvement in the total factor productivity in the banking sector. Also empirical research will be done to assess the difference between pre and post-acquisition performance using various financial indicators as measures. This analysis of merger and acquisition activities will broaden the compass of existing studies on post merger performances which have relied on accounting or stock market data and or have compared post merger financial performance to pre merger.

1.6 Outline of the Thesis

The thesis consists of six chapters.

Chapter one of the study will be introductory in nature and will try to introduce the areas under research, the probable motive for choosing the particular area of research, the research aims, sampling procedure, collection of data and its analysis and overall research will be given in brief.
Chapter two highlights the conceptual issues in Mergers and Acquisitions in India, it not only provides good understanding on the Indian banking system, but also identifies remaining problems and new challenges from a forward-looking perspective. Ascertain the theoretical economic grounds or motives for mergers in banking sector in India. The purpose is to describe the development process of the banking system and to provide comprehensive background knowledge about the banking system and its on-going reform. It starts with the origin of the banking system and its role in the centrally-planned economy about half a century ago. Then it depicts the reform process that transforms the banking system serving a centrally-planned economy into the one to be viable in a market-based economy.

Chapter three reviews the bank efficiency literature. It discusses brief review on bank efficiency literature worldwide in general; particular attention is paid to bank efficiency studies in developing countries and transition economies. The section provides guidance for this study in terms of theoretical foundation, research direction, objectives, and methodologies. Moreover, critical review of existing literature helps identify gaps to be filled in.

Chapter four gives the methodology adopted for this research, along with the research design. It describes the sample, data collection and variables used. The hypothesis of the study shall also be given in this chapter along with the empirical model specification for estimating bank efficiency.
Chapter five presents the processed data using tables and charts. The hypothesis will be accepted or rejected in this chapter. At the end of this chapter, a summary of findings will also be provided.

Chapter six concludes the thesis by summarising the main findings and the contributions for practitioners and academia. This chapter also identifies the limitations of the current study and concludes with a set of recommendations for future research.