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Mergers and Acquisitionsin the Indian Public Sector Banks (PSBs) – An analysis

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ABSTRACT

Banks are the lifeline of any economy and the economic growth of any country is dependent development of its banking sector. Public Sector Banks (PSBs) dominate the banking sector in India and have been critical to the growth of the country, post their nationalization in 1969. In order to further strengthen the Indian banking sector, Govt. of India (GoI) has been merging various PSBs to improve inter alia the financial profile of banks so as to augment their lending capacity. This paper evaluates the impact of mergers/acquisitions on the financial profile of two large PSBs, e.g., State Bank of India (SBI) and Bank of Baroda(BoB). For the purpose of the analysis, financial data for both the aforesaid banks over the last 5-9 years have been examined to ascertain if there has been any material change in their financial profile post-merger. The result points out the following:

- *In the short-term, there has not been any material change in the financial profile of the mergedbanks, as the stronger/larger banks' financial profiles have been impacted by the weaker banks' financial profiles.*
- *By merging the weaker/smaller banks with the stronger/largerbanks can help GOIto abdicate the responsibility of bank recapitalization to the larger bank, which generally can raise capital because of its strong standalone credit profile.*

The stakeholders may take into account the above findings whilst preparing the blueprint for the merger of the rest of the PSBs, if so desired.

Keywords: Mergers, financial profile, capitalization, Non-Performing Assets (NPA), Gross NPA, Net NPA, Current Account and Savings Account (CASA), Return on Equity (ROE), IRR (Internal Rate of Return), Price/Book (P/B)

1. INTRODUCTION

The Scheduled Commercial Banks in India can be classified into fivebroad categories: viz., Public Sector Banks (PSBs), Private Sector Banks, Foreign Banks, Co-operative Banks, and Regional Rural Banks.

The economic growth in a developing country is *inter alia* preceded by the credit growth. With a view to 1) mobilize savings (e.g., deposits) from the far-flung/vast hinterland, and 2) ensure smooth credit flow to various productive sectors of the economy, Govt. of India (GoI), in 1969 (and again in 1980), nationalized the banking sector. These banks, known as PSBs, have played a vital role for the growth of the Indian economy by mobilizing deposits and channelizing them to various productive sectors of the economy. With a view to bring in more innovation, competition, and productivity into the banking sector, GoI, in 1994, threw open the sector to private players.

Over the past few years, the PSBs' financial performance and growth levels had remained sub-par (vis-à-vis private sector banks), and GoI, being the primary shareholder, had been forced to infuse significant amount of capital to the weaker PSBs to maintain their lending capacity. Also, 1) with the entry of foreign banks, 2) increasing availability of alternative channels of financing (e.g., private equity, Non-Bank Finance Companies, bond markets, foreign currency borrowings, etc.), and 3) large funding needs of the individual Indian corporates, there was a need to build larger banks (especially, amongst the PSB stable) which can compete effectively in the global markets.

MERGERS IN THE INDIAN BANKING SECTOR

Mergers and Acquisitions(M&A) in the Indian banking sector in the past was primarily driven by the following:

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- Resuscitate a weak/smaller private sector bank by merging it with large/strong private sector bank (e.g., Bank of Madura and Bank of Rajasthan with ICICI Bank) or PSB (Global Trust Bank with Oriental Bank of Commerce, Nedungadi Bank with Punjab National Bank).Reserve Bank of India (RBI), along with GoI, played an active role in these mergers to ensure retail depositor protection.
- Commercial reasons for complementary product/geography or scaling up (e.g., HDFC Bank with Centurion Bank of Punjab, ING Vyasya with Kotak Mahindra Bank)– however, stringent regulatory framework prevented large scale M&A amongst the banks.

Mergers amongst the PSBs

In line with the aforesaid challenges, GoI has been evaluating merger of PSBs over the last decade – as seen from the adjoining table. The broad rationale for the mergers is as follows:

Creating large, strong nationalized banks, with ability to absorb asset quality shocks: PSB space was fragmented about 3 years back with presence of 27 banks, and each having relatively smaller market share (except SBI with market share of ~20%). GoI's rationale behind mergers was consolidation in the banking space, to form larger and stronger banks. The two mergers in the last 2-3 years along with the four proposed mergers may lead to a significant consolidation in the PSB space, with top 7 players now accounting for ~58% of the banking sector advances, while the residual 5 PSBs will account for only 5.7% (in banking advances). The resulting merged banks are expected to have greater diversification across clients, products and geographies. They are also projected to have stronger balance sheets over a period of time, as the largest amongst merging banks will transmit the 'best practices' into the smaller/weaker banks.

Fiscal	# PSBs at the start of fiscal	Event	# PSBs at the end of fiscal
FY2018	27	Merger of SBI with 5 associates and BhartiyaMahila Bank in Apr 2017	21
FY2019	21	IDBI privatized in Jan 2019, with ownership of LIC of India	20
FY2020	20	BoB merger with Vijaya and Dena Bank w.e.f. Apr 01, 2019	18
	18	Announced merger of 10 PSBs into 4 in August 2019: • Punjab National Bank, Oriental Bank of Commerce, United Bank of India • CanaraBank and Syndicate Bank • Union Bank, Andhra Bank, and Corporation Bank • Indian Bank, and AllahabadBank	12* (may happen in FY2021)

Source: Government reports and announcements

- **Operational efficiency through synergies, though to be realized over medium to long term:** The criteria for selecting banks for merger is: 1) complementary market/product presence, 2) ability of the larger/stronger bank to assimilate smaller/weaker banks, 3) filling in the shortfall of senior management talent pool, 4) re-deploying the surplus workforce to fill in the shortfall in the senior management talent, 5) GoI's positive experience from the earlier PSB mergers. However, there may not be any immediate operational synergies, and the same would be realized over time.

The current paper examines the after-effects of the mergers happened in the PSB space, with two case studies – e.g., merger of SBI with its associates and BhartiyaMahila Bank, and that of Bank of Baroda with Dena Bank and Vijaya Bank.

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2. REVIEW OF LITERATURE

- The study of Pradeep Kaur, Gian Kaur(2010)on the cost efficiency of the merging banks of India for the period 1990-91 to 2007-08 finds that mergers led to higher level of cost efficiencies for the merging banks. The study also finds that the Indian banking sector uses the merger of banks to restructure the weak and financially distressed banks. It also suggests that stronger banks should not be merged with weaker banks as it weakens the stronger bank's asset quality, and hence, strong banks should be merged with strong banks.
- Ritesh Patel and Mitesh Patel'sstudy (2015) on the effect of bank mergers on their financial performance is conducted by taking four banks(two PSBs and two private) for a period 10 years, i.e., 5 years each before and after the merger. The study finds that, overall, the mergers affect the financial position of a bank positively.
- Azeem Ahmad Khan(2011) studied the M&A in the Indian Banking sector in post liberalization regime to examine the pre- and post-merger financial performance of banks.The case study of the merger of NedungadiBank with PNB shows a sign of improvement in the gross profit margin, return on capital employed, return on equity and debt/equity position of the merged bank.
- Dr. K A Goyal and Vijay Joshihave done a research on the mergers in the banking industry in India and found that it is highly useful for the survival of weak banks. Some private banks like ICICI bank have taken M&A as a tool for increasing their geographic footprint, particularly in the rural areas.
- A study byR. Venkatesha and K. Majunath (2013) titled 'The impact of mergers and acquisitions on the financial performance of IDBI Bank',reveals that the merger of UWB Bank with IDBI Bank helped IDBI Bank to additionally provide retail banking service,in addition to the existing developmental banking. The merger also provided added advantages like geographic expansion, e.g., ATMs, new branches, internet banking, etc., to IDBI Bank.

3. SCOPE AND HYPOTHESES OF THE STUDY

Scope

To evaluate financial performance of two large PSBs, e.g., State Bank of India (SBI) and Bank of Baroda (BoB) pre- and post-merger with other PSBs

Hypotheses

There is no significance difference in the financial performance, post-merger for bothBoB and SBI in the short term.

4. RESEARCH GAP

It would be difficult to completely assess the financial performance of the merged entity as the timeframe is quite small (post-merger), and completely disregarding the extant macro-economic operating environment. The researchers down the line may consider adding various other financial/non-financial parameters over a longer period of time to adequately assess the merged entity's credit profile.

5. FINANCIAL PERFORMANCE ANALYSIS

The consolidation of PSBs started in August 2008 by merging SBI's associate bank, State Bank of Saurashtra (SBS), followed by the merger of State Bank of Indore (SBInd) in August 2010 to itself. Subsequently, the other 5 Associate Banks, namely,State Bank of Bikaner & Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala and State Bank of Travancore, and BharatiyaMahila Bank were merged with SBI with effect from April 1, 2017. In parallel, BoB merged Vijaya Bank and Dena Bank with itself with effect from April 01, 2019, to become the 2nd largest PSB in India.

A. Analysis of BoB's financial profile (FY2014-FY2019)

The financials of BoBpre-merger (2014-2019) and post-merger (H1FY2020, September 30, 2020) have been taken into account as the merger of BoB with Dena and Vijaya Bank was with effect from April 1, 2019; hence, the first set of merged detailed financials available were for Q1/H1FY2020.The financials of BoBare shown in the table below. We have also provided the pre-merger financials of Vijaya Bank and Dena Bank in the subsequent tables below. The source of these data has been Annual Reports and/or Investor Presentations

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of the respective banks. It may be noted that BoB was the larger bank, whilst Dena and Vijaya Bank were the smaller banks. Also, prior to merger, Dena Bank's financial profile (e.g., capitalization, advances profile, earnings/profitability, etc.) were weaker than that of BoB and Vijaya Bank.

Particulars	UoM	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	H1FY20
Size								
Overall business	INR Cr	965 900	1 045 625	957 808	1 010 186	1 018 747	1 107 509	1 531 470
No. of customers	Mn	60		60	71	78	86	130
Shareholder returns								
XIRR share price	%	5.27%	10.95%	-12.97%	13.19%	-17.46%	-9.34%	-29.88%
RoE	%	12.62%	8.53%	-13.42%	3.43%	-5.60%	0.85%	2.04%
P/B	Times	0.86	0.91	0.85	0.99	0.87	0.74	0.50
Efficiency								
Cost/Income	%	43.44%	43.63%	50.30%	45.86%	45.87%	45.56%	45.84%
Business/employee	INR Cr	10.40	18.89	16.80	17.49	17.66	18.88	
Deposit base								
CASA base	INR Cr	120 381	136 752	132 539	173 594	192 323	208 404	296 792
CASA (%)	%	31.76%	33.01%	33.57%	39.44%	41.18%	35.04%	37.88%
Capital								
Tier I capital	INR CR	34 207	38 856	22 996	39 709	42 650	47 393	62 612
Tier I capital (%)	%	9.54%	10.14%	10.79%	9.93%	10.46%	11.55%	10.91%
Advances profile								
Gross NPAs	%	2.94%	3.71%	9.99%	10.46%	12.26%	9.61%	10.25%
Net NPAs	%	1.52%	1.89%	5.06%	4.72%	5.49%	3.33%	3.91%

Source: Financial report of Bank of Baroda The perusal of the financial data reveals the following (NA = Not Available)

- BoB's size of business (i.e., deposits + advances) and the customer base has shown an increase with the merger of Dena/Vijaya Bank. Whilst there has not been any disaggregated region-wise data on deposits/advances, it is reasonable to assume that the deposit/advances would have been more geographically broad-based, considering that Vijaya Bank was more entrenched in the Southern region, whilst Dena Bank has been focused primarily in the Western region.

Vijaya Bank	UoM	2017	2018	2019
Efficiency				
Cost/Income	%	53.06%	47.53%	61.32%
Business/employee	INR Cr	15.51	18.1	NA
Deposit base				
CASA base	INR Cr	37 398	39 873	44 288
CASA (%)	%	28.10%	25.35%	25.19%
Capital				
Tier I capital	INR Cr	8 647	11 479	NA
Tier I capital (%)	%	9.96%	11.71%	NA
Advances profile				
Gross NPAs	%	6.59%	6.34%	6.58%
Net NPAs	%	4.36%	4.32%	3.08%

Source: Financial report of Vijaya Bank

- The low-cost/sticky deposit (e.g., Current Account and Savings Account – CASA) base/quantum has improved with the merger of banks, whilst there is no appreciable change in the CASA proportion post-merger – as the higher CASA proportion of Dena Bank is negated by lower CASA base of Vijaya Bank.
- The advances profile (i.e., Gross and Net NPAs) of the merged entity deteriorated

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Dena Bank	UoM	2017	2018	2019
Efficiency				
Cost/Income	%	62.01%	67.82%	94.26%
Business/employee	INR Cr	13.69	13.25	NA
Deposit base				
CASA base	INR Cr	43 222	42 485	43 240
CASA (%)	%	37.93%	40.03%	42.96%
Capital				
Tier I capital	INR Cr	7 523	6 426	NA
Tier I capital (%)	%	9.05%	8.81%	NA
Advances profile				
Gross NPAs	%	16.27%	22.04%	10.91%
Net NPAs	%	10.66%	11.95%	4.80%

Source: Annual reports of Dena bank during H1FY2020 primarily on account of higher NPA levels of Dena Bank and weak operating environment.

- BoB'sTier 1 capitalization has shown a decline during H1FY2020 due to low capitalization of Dena Bank pre-merger – this is in spite ofGoI cumulatively infusing INR 7,145 crores into (Dena) Bank for the 3 years preceding merger to improve its capitalization levels. However, BoB, being the 2ndlargest PSB post-merger, is expected to raise capital on its own without being dependent on GoI going ahead.
- The cost/income ratio did not exhibit any material deterioration post-merger in spite of the weak ratios of Dena and Vijaya Bank, due to the large sizeof BoB (vis-à-vis Dena and Vijaya Bank).
- The share prices, and Price/Book parameters of BoB have exhibited a downward trend due to the anticipated deterioration in various credit parameters of the merged entity, more particularly, on account of weak financial profile of Dena Bank pre-merger.

As can be seen from the aforesaid discussion,BoB'sfinancial profile did not exhibit any material change in the first 6 months of post-merger, may be due to 1) the combined size of Dena and Vijaya Bank was smaller than that of BoB, 2) BoB's stronger financial profile pre-merger (except advances profile)balancing the weaker financial profile of Dena/Vijaya Banks, and 3) merger related synergies and integration is yet to play out fully.

B. Financial profile of SBI (2010-2019)

The size of State Bank of Saurashtra(SBS) and State Bank of Indore (SBInd) individually were much smaller than SBI, though the combined size of the balance Associate Banks (and BharatiyaMahila Bank) may have material impact on the merged balance sheet of SBI. Accordingly, we have taken into account the financials of SBI from FY2010 (March 31, 2010) onwards for analysis purposes. The Associate Banks

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Particulars	UoM	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Size											
Overall business	INR CR	1436030	1690652	2 043 647	2 281 297	2604238	2 876 819	3 194 422	3 615 829	4 641 224	5 097 263
No. of customers	Mn					219.2	273.2	301.2	337.5	424.2	435.1
Shareholder returns											
XIRR share price	%	92.27%	31.52%	-22.92%	-2.70%	-9.02%	41.02%	-28.96%	49.96%	-14.75%	30.31%
RoE	%	14.84%	12.84%	14.36%	15.94%	10.49%	11.17%	7.74%	7.25%	-3.78%	0.48%
P/B	Times	2.00	2.70	1.67	1.43	1.21	1.55	1.05	1.49	1.15	1.30
Efficiency											
Cost/Income	%	52.59%	47.60%	45.23%	48.51%	52.67%	49.04%	49.13%	47.75%	50.18%	55.70%
Business/employee	INR CR	6.36	7.05	7.98	9.44	10.64	12.34	14.11	Data not provided		
Deposit base											
CASA base	INR CR	346563	430453	458 120	559 274	580197	637760	717 332	890 409	1 187 295	1 287 294
CASA (%)	%	46.67%	49.82%	46.64%	46.50%	44.43%	42.88%	43.84%	45.58%	45.68%	45.75%
Capital											
Tier I capital	INR CR	64117	63901	82 125	94 947	109547	117157	133 035	161 644	195 820	205 238
Tier I capital (%)	%	9.45%	7.77%	9.79%	9.49%	9.72%	9.60%	9.92%	10.35%	10.36%	10.65%
Advances profile											
Gross NPAs	%	3.05%	3.28%	4.44%	4.75%	4.95%	4.25%	6.50%	6.90%	10.91%	7.53%
Net NPAs	%	1.72%	1.63%	1.82%	2.10%	2.57%	2.12%	3.81%	3.71%	5.73%	3.01%

Source: Annual report of SBI & investors presentation

The perusal of the financial data reveals the following

- Size of the business (deposits + advances) have shown an increase with each of the mergers, and more particularly, after the merger of the 5 Associate Banks with SBI, along with the increase in the customer base. Whilst there has not been any disaggregated region-wise data on deposits/advances, it is reasonable to assume that the deposit/advances would have been more geographically broad-based (post merger), considering that some of the Associate Banks were hitherto focused on specific regions in the country.
- The low-cost/sticky deposit (e.g., Current Account and Savings Account – CASA)base has improved with the merger of banks, whilst there is no appreciable change in the CASA proportion post-merger.
- The capital base has shown an increase due to the merger, whilst Tier 1 capitalization has shown an improvement due to higher capitalization of SBI pre-merger. SBI has been able to raise capital on its own in June 2017 aggregating to INR 15,000 crores to support the overall capitalization of the merged entity. It may be noted that this dispensed Govt. of India of the need to provide capital from its own resources.
- The advances profile of the merged entity deteriorated during FY2018 and FY2019 (vis-à-vis FY2017 – pre-merger) primarily on account of higher NPA levels of the associate banks and weak operating environment.
- The cost/income ratio exhibited some deterioration post merger (FY2018 and FY2019 financials) due to merger related expenses (i.e., IT system integration, employee rationalization, etc.) as well as the income decline on account of weak advances profile. However, the Business/Employee data did exhibit steady improvement during FY2010-16 due to higher efficiencies post the mergers with SBS/SBInd..
- There is no definitive conclusion to be derived from the share prices, Return on Equity, and Price/Book parameters,asthey may have been reflective of the underlying financial performance – which inter alia may have been a function of the operating environment and merger related developments.

As can be seen from the aforesaid discussion, SBI's financial profile did not exhibit any material change in the last 2 years post-merger, may be due to the large capital raise by SBI post-merger, though the advances

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profile was impacted due to the weak advances profile of some of its Associate Banks and subduedmacro-economic operating environment.

6. CONCLUSION

- As seen from the aforesaid analysis, there has not been a material change in the credit profile of SBI and BoB post-merger. We can presume from SBI's merger, which is at least 2 years' old, thesynergy benefits or quantitative gains from these mergersis yet to play out fully. Additionally, the underlying macro-economic operating environment remains weak, resulting in volatility in the advances profile, which has affected profitability, RoE, and share prices.
- One may review the overall financial performance of these merged entities once the merger related integration smoothens out and all synergies are reaped, and under a more stable macro-economic operating environment.
- In the aforesaid context, it may be presumed that GoI, as the largest shareholder, has used the following criteria for selecting PSBs for merger: 1) ability of the larger/stronger bank to assimilate smaller/weaker banks by raising capital independently from the broader market, 2) complementary market/product presence, 3) smoother integration (i.e., similar IT systems), and 4) transfer of 'best practices' in management and filling in the shortfall of senior management talent pool.

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