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**RESEARCH METHODOLOGY**

**RESULTS & DISCUSSION**

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## ASSESSMENT OF ECONOMIC VALUE CREATION OF SELECT INDIAN PUBLIC SECTOR BANKS: A COMPARATIVE STUDY

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### ABSTRACT

*Economic Value Added (EVA) has received a lot of recognition as a measure of shareholder value creation. While the measure has been widely used for the purpose all over the world, many research studies have appeared to examine variety of issues related to EVA. An attempt is made in this paper to determine shareholders value (in terms of economic value added) of selected public sector banks during the last ten years. I.e. since 2004-05 to 2013-2014, and in our study equity approach has been followed to compute EVA. During the analysis the values of EVA and their rankings, we found that economic value added which a bank must earn to maintain its viable existence, has been lost by many banks while earned by many others in different periods.*

### KEYWORDS

EVA (Economic Value Added), Share Holder Value Creation.

### INTRODUCTION

The financial sector in India, as well as over the world, continues to be one of the primary engines of economic growth. One of the key constituents of the financial sector in India is the banking system. Since the early 1990s, structure of the banking sector has significantly changed due to deregulation, liberalization and divestment of public banks. The economic liberalization has changed the business environment in the country. During the pre-liberalization period, the industry was merely focusing on deposit mobilization and branch expansion. Based on the recommendation of the Narasimhan Committee, the Government of India started diluting its stake in public sector banks. These developments are expected to have important implications for operating performance and profitability of the banking system. From the point of view of the shareholders, it is especially important to know the efficiency level of banking firms. Whether banks have created enough value is an important point for the shareholders to focus for an organization. The shareholders' value depends on the performance of the banks.

Economic Value Added (EVA), have also appeared on the scene to measure the corporate financial performance. Of these new performance measures, EVA has gained popularity as a performance measure and a yardstick of shareholder value creation. The concept of Economic Value Added (EVA) helps investors to measure the return over and above minimum return (i.e. cost of equity) as expected by investors before making investments. Banks and financial institutions have some characteristics that are peculiar to their business. Due to this, the ratios and other measures of performance when applied to banks need to be modified in order to obtain the relevant information. Same is true for calculation of EVA also.

The standard and widely accepted method for calculating EVA is,  $EVA = NOPAT - (\text{invested capital} \times WACC)$ . This method is known as 'entity method'. Another method is equity approach. Thamby and Baheti (2001) followed the method proposed by Tom Copeland, Tim Koller and Jack Murrain in 1996. Parsuraman (2000) also proposes equity approach for valuation of banks. He mentions that the equity approach is more suited to banks compared to the entity approach. In this paper we have also followed equity approach to compute EVA. In the case of banks, the equity approach is recommended:

The formula for EVA is:  $EVA = \text{Net Profit after Taxes} - (\text{Equity} \times \text{cost of Equity})$

### REVIEW OF LITERATURE

During the last two decades, several researchers, corporate professionals, and consultant firms engaged in the field of accounting & finance have been paying their close attention on the EVA, and admitting the limitations of 'traditional' measures of performance. But majority of them have drawn inferences about the theoretical discussion of it and a few of them have concentrated to make the EVA concept as a legitimate tool of corporate (or banks) financial performance measurement. The present section briefly thrashes out the notable research works carried out so far by the leading scholars in the field.

**Padgett (1996)** comments on a study conducted by Stern Stewart & Company among top 100 US banks. The result of the study was not satisfactory since the average EVA made by these banks is only 97 basis points over their cost of capital.

**Uyemura (1997)**<sup>22</sup> observed that over the last 20 years, bankers have toiled with a variety of risk management and profit concepts, such as matched-maturity funds transfer pricing, duration analysis and activity based costing accounting. Today, the interest has developed in Value-at-Risk (VAR) capital allocations and risk adjusted return on capital. Such tools are important to understand and implement when analyzing specific transitions; however, a top down approach be the best choice for portfolios or lines of business. The article describes a 'top-down' approach to risk management, easily understood and simpler to implement and lower in cost than traditional approaches by using economic value added (EVA) concept.

**Banerjee (1999)** concluded that EVA is an important explanatory variable of the shareholder value. The study also found the companies, which have started disclosing EVA results in their annual reports, to face a direct impact on the stock price.

**Bennett (2000)**, a senior partner of Stern Stewart & Co., suggested that compared with EPS, EVA is a far better way to keep score, a more challenging and meaningful goal, a more useful decision guide and a truly superior metric for determining incentive compensation.

**Parasuraman (2000)** in India found that 18 banks out of 28 banks considered for study were not creating any economic value. But, he found that EVA only for one year (1998-99) and samples include foreign banks too.

**Ashok Thamby and et al. (2001)** has analyzed the performance of 12 Indian banks for a period of three years, starting 1995-96 and ending 1997-98. The result of their study also showed that Indian banks did not create economic value.

**Fernandez (2003)**, comments that a company destroys the wealth of the organization when EVA is negative. So, can it be concluded that Indian banks are not creators but destroyers of wealth? But, at the same time they are making profits. So, what will be the present EVA structure? Further, they attributed two reasons for not creating economic value: (1) Overcapitalization and (2) Lower returns from the banking business. The former can be rejected since Indian banks have been maintaining healthy capital adequacy ratios since the Reserve Bank of India started initiating the same. The above study too concluded on similar line.

The second attribute is supported by stating that high NPAs and low employee productivity in banks can be the reasons for not creating economic value. The present study examines the validity of these conclusions, apart from computing EVA of banks.

## STATEMENT OF THE PROBLEM

After reviewing the above studies we have been unable to find any exhaustive academic research in the area of Economic value added (EVA), further No concrete proof is available on the assessment of performance applying value adding measures in PSBs. Hence, there is research gap exist in measuring the performance of PSBs in India applying value addition metric.

## OBJECTIVES OF THE STUDY

The present study aims to achieve the following objectives:

1. To assess the performance in terms of Economic Value Added (EVA) of select Indian public sector banks.
2. To identify top banks who generate value for its shareholders.
3. To offer suggestions on the basis of findings for the improvement of Indian nationalized banks

## RESEARCH METHODOLOGY

The following methodology has been adopted to conduct our study;

We have computed EVA as per the equity approach with the following formula:

**EVA=Net Profit after Taxes- (Equity\* cost of Equity)**

In order to calculate EVA as per equity approach, we need profit after tax, book value of equity and cost of equity. Profit after Tax (PAT) has been taken from Prowess (CMIE database). As regards to the value of equity (invested capital). It has been calculated from the financial data collected from the PROWESS with minor adjustments.

In paid-up equity capital of the banking company, free as well as specific reserves were added while accumulated losses were reduced. However, revaluation reserves were not included as these are not surplus coming out of the routine operations of banks and are not part of equity capital. And Cost of equity has been calculated as per Capital Asset Pricing Model (CAPM).

To compute cost of equity, we need risk-free rate, beta coefficient of banks, market risk premium. We have collected risk-free rate (being average auction rate on 364- days Govt. of India treasury bills) from the website of Reserve Bank of India. As regards to the beta coefficient of banks, beta for each stock has been obtained from prowess, the databases of Centre for Monitoring Indian Economy. And as far as Market risk premium is concerned it has been taken as 9% by some of the leading firms like Hindustan Lever, Infosys etc, for calculating EVA for their firm. As 9% is quite a reasonable premium for upholding market risk.

Therefore we have also picked-up as same with the assumption that investors expect this much as minimum excess return (over risk-free return) by investing in banking stocks.

## SOURCES OF INFORMATION

The present study is based on secondary source of information. To speak specifically; this study covers a period of 10 years starting from 2004-05 and ending 2013-14. Among 27 nationalized banks 7 Banks were excluded due to non-availability of data.

We could get the required data for 20 nationalized banks which are listed on Bombay stock exchange (BSE). The data has been collected from Prowess, the database of Centre for Monitoring Indian Economy (CMIE). The financial statements (i.e. income and expenditure statement and the balance sheet) of all the selected banks have been picked-up-from the above database. And we have also gathered required data from RBI websites.

## STRUCTURE OF THE STUDY

The paper is divided into five different sections. Section I covers a brief introduction to the topic. Section II reviews the existing related literature on the study. Section III gives methodology used in the study. Section IV presents the results and discussion of the study. Last but not the least, Section V concludes the paper.

## RESULTS AND DISCUSSION

The Indian Banking Industry has been in the rapid state of metamorphosis. Post reforms, a lot of changes have taken place in the banking landscape. Still. A lot seems to be done. The development of economy put thrust on the banking system in the country. Only a competitive and efficient banking system in the country can provide momentum for the real growth in the economy. Indian banks can no longer rely on the old benchmarks of deposits and advances. Now, they have to focus on the value creation in the banking enterprise.

The banks which can create value can only survive and remain; others have to close down their shops. It is in the context, it becomes imperative to measure the extent of value creation in the banking companies. Economic value Added (EVA) is a metric which not only measure the extent of value creation rather tell how value creation can be done and sustained at each and every level of the organization.

**TABLE 1: ECONOMIC VALUE ADDED: COMPUTED VALUE AND RANKINGS OF BANKS (Rs. In Crore)**

| NAME OF THE BANK               | 2004-05 | RANK | 2005-06 | RANK | 2006-07 | RANK | 2007-08 | RANK | 2008-09 | RANK |
|--------------------------------|---------|------|---------|------|---------|------|---------|------|---------|------|
| Allahabad Bank                 | 265.23  | 4    | 194.68  | 3    | 109.81  | 3    | 180.01  | 6    | -125.06 | 17   |
| Andhra Bank                    | 244.18  | 6    | 28.84   | 9    | -56.12  | 15   | 13.12   | 14   | 34.52   | 15   |
| Bank Of Baroda                 | -117.62 | 16   | -340.1  | 19   | -351.27 | 18   | -376.58 | 19   | 158.92  | 7    |
| Bank Of India                  | -375.22 | 19   | -138.25 | 13   | 63.19   | 8    | 338.72  | 2    | 817.9   | 2    |
| Bank Of Maharashtra            | -36.57  | 15   | -179.03 | 16   | -1.46   | 13   | 38.69   | 12   | 43.53   | 13   |
| Canara Bank                    | 225.67  | 7    | 254.59  | 2    | 77.61   | 6    | 151.43  | 8    | 396.81  | 5    |
| Central Bank Of India          | NA      | NA   | -255.79 | 18   | 33.77   | 11   | -40.24  | 16   | -79.62  | 16   |
| Corporation Bank               | -12.16  | 14   | -12.86  | 10   | 98.17   | 4    | 172.49  | 7    | 481.31  | 4    |
| Dena Bank                      | -122.01 | 17   | -38.43  | 11   | 49.15   | 9    | 43.01   | 11   | 111.61  | 9    |
| Indian Overseas Bank           | 257.27  | 5    | 300.94  | 1    | 311.33  | 1    | 232.57  | 3    | -284.75 | 19   |
| Oriental Bank Of Commerce      | -272.75 | 18   | -376.84 | 20   | -662.18 | 19   | -221.32 | 18   | 76.86   | 10   |
| Punjab National Bank           | 266.55  | 3    | 48.27   | 7    | -121.12 | 17   | 230.81  | 4    | 921.48  | 1    |
| State Bank Of Bikaner & Jaipur | 8.4     | 13   | -79.31  | 12   | 24.5    | 12   | 15.36   | 13   | 52.69   | 12   |
| State Bank Of India            | 472.24  | 1    | -204.36 | 17   | -1007.9 | 20   | -2199.7 | 20   | -1228.2 | 20   |
| State Bank Of Mysore           | 102.26  | 10   | 81.19   | 5    | 72.01   | 7    | 97.92   | 9    | 75.01   | 11   |
| State Bank Of Travancore       | 71.3    | 11   | 41.35   | 8    | 48.46   | 10   | 79.43   | 10   | 214.11  | 6    |
| Syndicate Bank                 | 106.12  | 9    | 125.03  | 4    | 185.17  | 2    | 185.97  | 5    | 141.77  | 8    |
| Uco Bank                       | 49.68   | 12   | -147.32 | 14   | -89.89  | 16   | -55.93  | 17   | 40.91   | 14   |
| Union Bank Of India            | 272.95  | 2    | 62.54   | 6    | 87.12   | 5    | 459.18  | 1    | 587.27  | 3    |
| Vijaya Bank                    | 129.1   | 8    | -150.65 | 15   | -5.23   | 14   | -31.78  | 15   | -161.96 | 18   |



## ECONOMIC VALUE ADDED: COMPUTED VALUE AND RANKINGS OF BANKS-contd

| NAME OF THE BANK               | 2009-10 | RANK | 2010-11  | RANK | 2011-12  | RANK | 2012-13  | RANK | 2013-14  | RANK |
|--------------------------------|---------|------|----------|------|----------|------|----------|------|----------|------|
| Allahabad Bank                 | 313.68  | 9    | 96.26    | 9    | 19.46    | 3    | -793.39  | 12   | -956.39  | 12   |
| Andhra Bank                    | 420.51  | 6    | 204.26   | 6    | -13.59   | 4    | -218.47  | 7    | -1176.48 | 13   |
| Bank Of Baroda                 | 1052.37 | 3    | 1178.65  | 2    | 467.25   | 1    | -753.8   | 10   | -1589.45 | 15   |
| Bank Of India                  | -281.43 | 18   | -384.38  | 17   | -1224.12 | 17   | -1679.48 | 18   | -2525.09 | 17   |
| Bank Of Maharashtra            | 120.35  | 12   | -124.33  | 16   | -218.08  | 13   | -35.68   | 2    | -616.94  | 10   |
| Canara Bank                    | 1277.24 | 2    | 1137.31  | 3    | -407.07  | 14   | -1146.26 | 15   | -1947.16 | 16   |
| Central Bank Of India          | 364.91  | 8    | 293.76   | 5    | -1242.86 | 18   | -1299.83 | 17   | -4011.7  | 19   |
| Corporation Bank               | 405.41  | 7    | 189.34   | 7    | -58.53   | 5    | -1072.07 | 14   | -402.5   | 6    |
| Dena Bank                      | -41.81  | 16   | -84.34   | 15   | -190.16  | 10   | -775.86  | 11   | -44.17   | 2    |
| Indian Overseas Bank           | -381.64 | 19   | -1064    | 19   | -1808.49 | 19   | -2253.72 | 19   | -104.36  | 3    |
| Oriental Bank Of Commerce      | -196.2  | 17   | -901.41  | 18   | -865.58  | 16   | -1252.89 | 16   | 60.15    | 1    |
| Punjab National Bank           | 1676.85 | 1    | 1243.48  | 1    | 222.68   | 2    | -689.55  | 9    | -2862.25 | 18   |
| State Bank Of Bikaner & Jaipur | 108.02  | 13   | 79.07    | 10   | -111.81  | 6    | -129.21  | 3    | -266.12  | 4    |
| State Bank Of India            | -779.09 | 20   | -2958.57 | 20   | -4293.81 | 20   | -4445.6  | 20   | -11996.5 | 20   |
| State Bank Of Mysore           | 178.25  | 11   | 33.58    | 11   | -206.03  | 11   | -206.96  | 6    | -409.35  | 7    |
| State Bank Of Travancore       | 266.14  | 10   | 142.04   | 8    | -212.51  | 12   | -188.12  | 4    | -564.42  | 8    |
| Syndicate Bank                 | 82.12   | 15   | -29.81   | 13   | -131.44  | 8    | 313.22   | 1    | -279.54  | 5    |
| Uco Bank                       | 444.83  | 5    | -14.49   | 12   | -131.08  | 7    | -800.12  | 13   | -615.11  | 9    |
| Union Bank Of India            | 897.31  | 4    | 357.95   | 4    | -465.54  | 15   | -517.12  | 8    | -1285.8  | 14   |
| Vijaya Bank                    | 93.66   | 14   | -65.05   | 14   | -155.44  | 9    | -201.24  | 5    | -700.6   | 11   |

Source: Compiled and Calculated data presented in CMIE Prowess data base.

While looking the values of EVA and their rankings, we get an early impression that economic value added which a bank must earn to maintain its viable existence, has been lost by many banks while earned by many others in different periods. To get a feel of the trend in economic value addition, I have enlisted the top five banks in terms of EVA (Table 1.2) a possible trend which comes out is that performance of Punjab national bank, bank of Baroda, bank of India and Indian overseas bank in terms of economic value creation.

TABLE 2: YEAR WISE TOP FIVE BANKS IN TERMS OF EVA

| Year    | Name of the Bank     | Rank |
|---------|----------------------|------|
| 2004-05 | State Bank Of India  | I    |
|         | Union Bank Of India  | II   |
|         | Punjab National Bank | III  |
|         | Allahabad Bank       | IV   |
|         | Indian Overseas Bank | V    |
| Year    | Name of the Bank     | Rank |
| 2005-06 | Indian Overseas Bank | I    |
|         | Canara Bank          | II   |
|         | Allahabad Bank       | III  |
|         | Syndicate Bank       | IV   |
|         | State Bank Of Mysore | V    |
| Year    | Name of the Bank     | Rank |
| 2006-07 | Indian Overseas Bank | I    |
|         | Syndicate Bank       | II   |
|         | Allahabad Bank       | III  |
|         | Corporation Bank     | IV   |
|         | Union Bank Of India  | V    |
| Year    | Name of the Bank     | Rank |
| 2007-08 | Union Bank Of India  | I    |
|         | Bank Of India        | II   |
|         | Indian Overseas Bank | III  |
|         | Punjab National Bank | IV   |
|         | Syndicate Bank       | V    |
| Year    | Name of the Bank     | Rank |
| 2008-09 | Punjab National Bank | I    |
|         | Bank Of India        | II   |
|         | Union Bank Of India  | III  |
|         | Corporation Bank     | IV   |
|         | Canara Bank          | V    |
| Year    | Name of the Bank     | Rank |
| 2009-10 | Punjab National Bank | I    |
|         | Canara Bank          | II   |
|         | Bank Of Baroda       | III  |
|         | Union Bank Of India  | IV   |
|         | Uco Bank             | V    |

| Year    | Name of the Bank      | Rank |
|---------|-----------------------|------|
| 2010-11 | Punjab National Bank  | I    |
|         | Bank Of Baroda        | II   |
|         | Canara Bank           | III  |
|         | Union Bank Of India   | IV   |
|         | Central Bank Of India | V    |

| Year    | Name of the Bank     | Rank |
|---------|----------------------|------|
| 2011-12 | Bank Of Baroda       | I    |
|         | Punjab National Bank | II   |
|         | Allahabad Bank       | III  |
|         | Andhra Bank          | IV   |
|         | Corporation Bank     | V    |

| Year    | Name of the Bank               | Rank |
|---------|--------------------------------|------|
| 2012-13 | Syndicate Bank                 | I    |
|         | Bank Of Maharashtra            | II   |
|         | State Bank Of Bikaner & Jaipur | III  |
|         | State Bank Of Travancore       | IV   |
|         | Vijaya Bank                    | V    |

| Year    | Name of the Bank               | Rank |
|---------|--------------------------------|------|
| 2013-14 | Oriental Bank Of Commerce      | I    |
|         | Dena Bank                      | II   |
|         | Indian Overseas Bank           | III  |
|         | State Bank Of Bikaner & Jaipur | IV   |
|         | Syndicate Bank                 | V    |

TABLE 3: EVA.DESRIPTIVE STATISTICS

| year    | N  | range    | minimum  | maximum | mean      | Standard deviation |
|---------|----|----------|----------|---------|-----------|--------------------|
| 2004-05 | 19 | 847.46   | -375.22  | 472.24  | 80.7695   | 208.5789           |
| 2005-06 | 20 | 677.78   | -376.84  | 300.94  | -39.2755  | 186.63231          |
| 2006-07 | 20 | 1319.25  | -1007.92 | 311.33  | -56.745   | 301.00807          |
| 2007-08 | 20 | 2658.91  | -2199.73 | 459.18  | -34.3435  | 542.12249          |
| 2008-09 | 20 | 2149.71  | -1228.23 | 921.48  | 113.754   | 444.49003          |
| 2009-10 | 20 | 2455.94  | -779.09  | 1676.85 | 301.074   | 577.19222          |
| 2010-11 | 20 | 4202.05  | -2958.57 | 1243.48 | -33.534   | 900.54602          |
| 2011-12 | 20 | 4761.06  | -4293.81 | 467.25  | -551.3375 | 1034.08136         |
| 2012-13 | 20 | 4758.82  | -4445.6  | 313.22  | -907.3075 | 1035.85495         |
| 2013-14 | 20 | 12056.65 | -11996.5 | 60.15   | -1614.691 | 2663.26965         |

Source: Computed through spss 20.0

The descriptive statistics for EVA Values has also been calculated through SPSS. (Table 1.3) This shows the range, minimum EVA Value, maximum EVA Value, mean EVA Value and standard deviation. If we look at the mean EVA Values, we find a very fluctuating trend with in some year, EVA values, EVA lost and some other years, EVA gained. Of course, degree of variability in terms of standard deviation has gone up every year.

## FINDINGS AND CONCLUSION

After the detailed analysis of financial data of the selected banks, it may be concluded that during the analysis the values of EVA and their rankings, we get an early impression that economic value added which a bank must earn to maintain its viable existence, has been lost by many banks while earned by many others in different periods. Further an overview of select banks' EVA for selected period (10 years) under study reflects that in many years banks have failed to add value to shareholder despite being in profits. It denotes that none of the banks are actually value generators. Therefore this demands an urgent attention and some solution to overcome this gap in competitiveness state of select of Indian banks.

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