Analysis of Performance of Select Merchant Banks in India – A Study

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Abstract: A merchant bank is a financial institution which facilitates providing capital to companies in the form of share ownership, instead of loans. They mainly engage in the business of issue management through selling, buying and underwriting of securities. They also provide corporate advisory services to the firm. Therefore they play the role of underwriter, advisor, manager and consultant. According to the US Federal Deposit Insurance Corporation, the term merchant banking is generally understood to mean negotiated private equity investment by financial institutions in the unregistered securities of either privately or publicly held companies. In this context, the paper highlights a comparison between Indian commercial and development banks engaged in merchant banking activities over five years and relative performance of the same in respect of various financial ratios.

Key-words: Merchant banking, financial services, issue management, private equity investment, liberalization.

1. Introduction

Financial services are an important component of financial system. The smooth functioning of financial system depends upon the range of financial services extended by the providers. Financial services have witnessed remarkable changes in the recent past after the implementation of "liberalization, privatization and globalization." Earlier the services provided by the commercial banks were mainly confined to accepting deposits and lending money in the mode of cash. Though financing was its main business and demand deposits were the only key feature, it suffered from various demerits such as:-

i) *Absence of proper records*: Ascertainment of the total indebtedness of some classes of borrowers, especially the farmers became difficult because of absence of proper records of land rights which, in turn, created the problems of over financing or of recovery.

ii) *Difficulty in verifying actual utilization of loans*: There was often misuse of funds in case of medium term loans, which created difficulty in verifying the actual utilization of funds.

iii) *Difficulty in judging the credit worthiness*: Due to lack of sufficient knowledge of the character of the borrower, it was difficult to judge their credit worthiness.

iv) *Lack of sufficient supervision*: Due to lack of sufficient supervisory staff in the bank, loans were misused.

Therefore effective monitoring became indispensible to fill up the above loopholes and hence the concept of merchant banking emerged.

Another important reason for the growth of merchant banking has been the developmental activities carried out throughout the country, exerting excess demand on the sources of funds for ever expanding industry and trade thus leaving a widening gap between the supply and demand of investible funds. In the circumstances, corporate sector had the only alternative to avail of the capital market services for meeting their long term financial requirements through capital issues of equity and debentures. With the growing demand for funds, there was pressure on the capital market that forced the commercial banks, share brokers and financial consultant firms to enter into the field of merchant banking. The result being that all the commercial banks and foreign banks now have their merchant banking windows. There has been a mushroom growth of financial consultancy firms and brokerage firms doing advisory functions and managing public issues in syndication with other merchant bankers. Therefore merchant banks have evolved as a financial institution primarily engaged in offering financial services and advice to corporations and wealthy individuals on how to use money. The term can also be used to describe the private equity activities of banking.

In older times, merchant banks were also known as "accepting and issuing houses" in the UK and "investment banks" in the USA. Usually they handled coastal trade and master's goods on a commission basis and financed risky venture projects, for which they charged heavy interest. They often incurred heavy losses. They accepted bills for payment. These were in addition to the merchant banking functions of commercial banking. In fact there was no distinction between the functions of merchant banking and commercial banking until 1932. Later the Glass Steagall Act, 1933, US, distinguished the functions of merchant banking from commercial banking. However, in 2000, the Clinton Administration allowed investment banks to discharge the functions of commercial banks in addition to their usual functions of investment banking. This was effected through an amendment in the Glass Steagall Act.

Although merchant banking activities were ushered in two decades ago, it was only in 1992 after the formation of Securities and Exchange Board of India that it has become operational. Today a merchant banker, who has the ability to merchandise, can create and expand a need and fulfill capital requirements.

In India, prior to the enactment of the Indian Companies Act, 1956 managing agents acted as issue houses for securities, evaluated project reports, planned capital structure and, to some extent, provided venture capital for new firms. Few share broking firms also functioned as merchant bankers. The need for specialized merchant banking services was felt in India with the rapid growth in the number and size of the issues made in the primary market.

As planning and industrial policy initiated since 1960s envisaged the setting up of new industries and technology, greater financial sophistication and financial services have become necessary requirements. Economic development requires specialist financial skills, finance companies for consumer lending and mortgage finance, agricultural banks for rural development and a range of government and government sponsored institutions. As new units were set up and business expanded, they required additional financial services which were then not provided by the banking system. To keep pace with this globalization and liberalization process in the banking system, the Government of India was very keen to bring the capital market in line with international practices through gradual de-regulation of the economy. It led to liberalization of the capital market in the country with more expectations from the primary market to meet the growing needs for funds for investment in trade and industry. Thus there was a vital need to strengthen the capital market which could only be achieved through structural modifications by introducing new mechanisms and new instruments, and by taking steps for safeguarding the interest of the investors through proper disclosures and transparency. Therefore, merchant banks came into existence. It serves a dual role within the financial sector-

- through deposits or sale of securities, they obtain funds for lending to their clients, and
- the other role is to act as agents in return for fee.

SEBI envisages a mandatory role for merchant banks in exercising due diligence apart from issue management, in buy-backs and public offer in takeover bids. Their underwriting and corporate financial services are all fee based.

The Banking Commission in its Report in 1972 has indicated the necessity of merchant banking service in view of the wide industrial base of the Indian economy. The Commission was in favor of separate institutions (as distinct from commercial banks and term lending institutions) to render merchant banking services. The Commission suggested that they should offer investment management and advisory services particularly to the medium and small savers. The Commission also suggested that they should be able to manage provident funds, pension funds and trusts of various types. Merchant banking services were formally initiated in the Indian capital markets when the then Grindlays bank received the license from Reserve Bank in 1967.

Following Grindlays bank, Citibank set up its merchant banking division in 1970. Consequent to the recommendations of Banking Commission in 1972 that Indian banks should start merchant banking services as part of their multiple services that they could offer to their clients, State Bank of India (SBI) started the merchant banking division in 1972. In the initial years, the SBI's objective was to render corporate advice and assistance to small and medium entrepreneurs. The commercial banks that followed State Bank of India in setting up merchant banking units were Central Bank of India, Bank of India and Syndicate bank in 1977; Bank of Baroda, Standard Chartered bank and Mercantile bank in 1978; United Bank of India, United Commercial Bank, Punjab National Bank, Canara Bank and Indian Overseas Bank in late seventies and early eighties. Among the development banks, ICICI started merchant banking activities in (1973), followed by IFCI (1986) and IDBI (1991). As of now there are 135 Merchant bankers who are registered with SEBI in India.

Not many but still some problems are faced by merchant banks, especially those operating in India. They are as follows:-

(a) *Industry compartmentalization*: A company which is in merchant banking business is expected to have expertise in underwriting, hire-purchase, leasing, portfolio management and money lending. But RBI does not permit merchant banking firms to get into these activities. So the same promoters have to set up different companies for different purposes. Management cost increases as a result of expertise pooling i.e., multiple use of same talent is not possible.

(b) *Regulations*: Though regulations are much better now, there is still scope for further improvement. Merchant bankers can be made more accountable and responsible. Professional qualification focused on merchant banking is not available. Industry is not well recognized and all the players do not play the same tune. This is specifically evident in comparison with insurance industry and mutual funds industry.

(c) *Malafide* practices: Corporate culture in India is better now, but still many corporate are unscrupulous and biased. Favored allotment of shares, tampering with project appraisal report to the bankers is common. Corporates like to use merchant banks for such malafide intentions.

In view of the above problems, merchant bankers face a challenging task in fine tuning their activities to the requirements of the growth pattern of the corporate sector, the industry and the economy as a whole. To meet these challenges merchant bankers need to be more vigorous and strategic in discharging their functions. They also have to adopt new ways and means in discharging their role. This necessitates an evaluation of the performance of merchant bankers operating at present with a view to determining their superlative financial performance and the extent to which merchant bankers are discharging their functions effectively and efficiently.

The study is divided into six sections. Literature review is discussed in Section-II. Section-III deals with the objective of paper. Research methodology is highlighted in Section-IV. Section-V discusses the analysis and findings. Section-VI concludes the study.

2. Literature Review

The merchant banking services dates back to the 17^{th} and 18^{th} century in the UK and USA. But it was not until the 1970s that the merchant banking practices started in India. Extensive research work has been carried out to analyse the various pros and cons of merchant banking practices followed in different countries. *Stanley Chapman* (1984) stated in his book about the evolution of the role of the merchant bankers, specially the market leaders like Rothschilds, Barrings, Warburgs, Schroders. *Ramesha* (2008) in his article "Merchant Banking" enumerated the history of merchant banking in the late 17^{th} and 18^{th} century in Europe. Merchant Banking started in Europe by merchant adventurers who were supported by wealthy groups of people. At that time, there was a network of overseas trading from where these merchant adventurers collected huge amounts of money to finance trade across different parts of the world. Other European colonies like Dutch merchant adventurers, French and Portuguese also started their merchant banking activities in the same manner. The article also consisted of modem merchant banking which has been considerably broadened to include a composite number of modem day skills such as role of an entrepreneur, financial advisor, investment banker, portfolio manager, underwriter etc. With these modified functions of merchant banking, the concept of merchant bank has evolved as any person engaged in the field of issue management either by making arrangements regarding buying, selling, subscribing to securities as manager, consultant, advisor or rendering any corporate advisory services in relation to such issue management is regarded as a merchant banker. Further, the author gives a step by step break-up of financial institutions performing merchant banking functions in India, together with objectives and activities of merchant bankers.

E.Gordon and K. Natarajan (2009) examined the concept, objectives, functions, types, origin and procedural requirements of merchant banking in India. *Valentine V. Craig* (2001), in his article, described the evolution of private equity market in the United States as the term merchant banking is generally understood as private equity investment made in the unregistered securities of public or privately held companies. *H.R. Machiraju* (2004) examined a comprehensive and updated version of the functions of merchant bankers apart from mandated functions. *Madhu Vij and Swati Dhawan* (2011) stated the basic concepts, functions, regulatory issues of merchant bankers. They have not only dealt with merchant banking and financial services sector in India but also with its various issues and dimensions in a well structured format.

Thus, merchant banking is not a recent origin. In India, many commercial, developmental, private financial institutions engage themselves in merchant banking activities as a separate activity of these institutions. SEBI has also laid down various rules, regulations, and procedures of merchant banking activities taken up by financial institutions. A systematic research on the performance of select merchant banking firms has not appeared in published form in India as yet. Accordingly, the proposed study aims at fulfilling this vacuum.

3. Objective of the Study

The objective of this study is to measure the relative performance of both commercial and development banks engaged in merchant banking activities in India.

4. Research Methodology

a) Sample selection: A sample of five merchant banks INDBANK Merchant Banking Services Ltd., CANBANK Financial Services Ltd., IDBI Capital Market Services Ltd., ICICI Securities Ltd., and SBI Capital Markets Ltd. has been selected for performance evaluation based on their continuous availability of data.

b) Nature of variables: Performance of selected merchant banks is evaluated based on three standard ratio categories i.e. Turnover ratio, Return ratio and Liquidity ratio to judge the profitability, solvency and liquidity positions. Two components of each ratio have been selected.

c) Consideration of time period: A recent time period comprising five financial years, from 2005 to 2009, has been selected as the period of study to evaluate financial performance of select merchant bankers in India.

d) Collection of data: The relevant data for the study have been the audited financial statements of five financial years of five banks and such data have been collected from the secondary source i.e. CMIE Prowess database.

e) Application of statistical methods: The analysis and interpretation of data are done graphically through time-series and cross-sectional analysis of five selected merchant banks. Time-Series analysis is conducted for each of the five selected banks in respect of two components of each ratio for five years in the study period ranging from 2005 to 2009. Cross-Sectional analysis gives an indication of the relative performance of five banks in relation to the individual three ratio categories i.e. turnover ratio, liquidity ratio, return ratio for each of the five financial years from 2005 to 2009.

5. Analysis and Findings

The analysis and interpretation of available data for the sample banks are presented below through charts and graphs.

Time-Series Analysis

The graphical presentations in the form of line graphs for each bank with respect to each ratio category over five years ranging from 2005 to 2009 are shown below.

Turnover ratios (times)

For time series analysis of each selected bank over the study period, two components of turnover ratio i.e., Finished Goods Turnover and Creditors Turnover are selected.

Figure 1: INDBANK Merchant Banking Services Ltd.

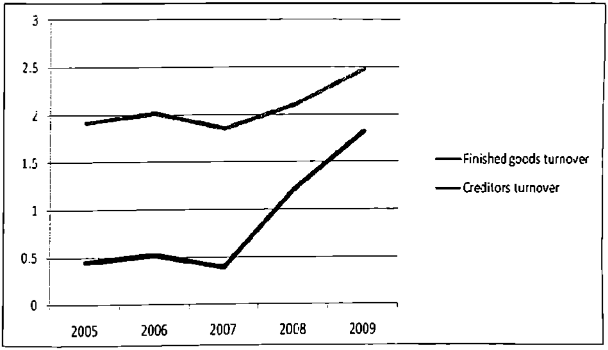


Figure 2: CANBANK Financial Services Ltd.

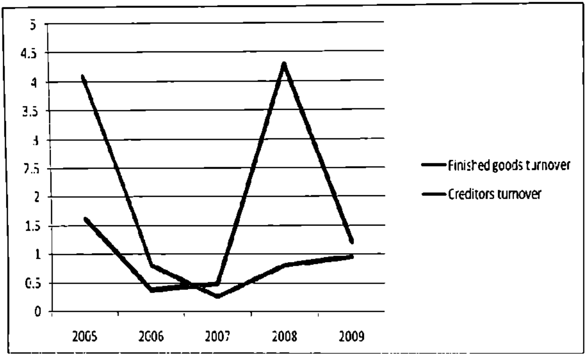


Figure 3: IDBI Capital Market Services Ltd.

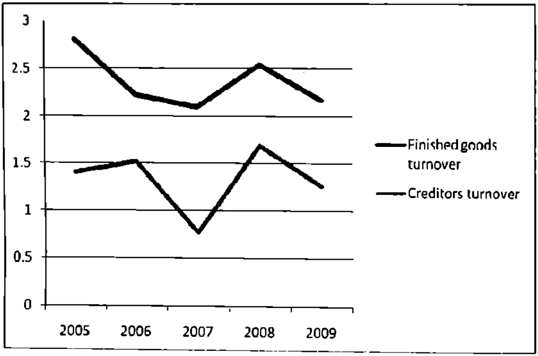


Figure 4: ICICI Securities Ltd.

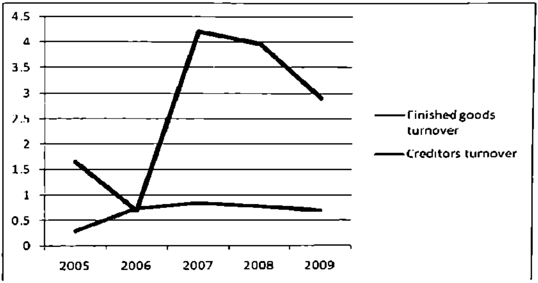
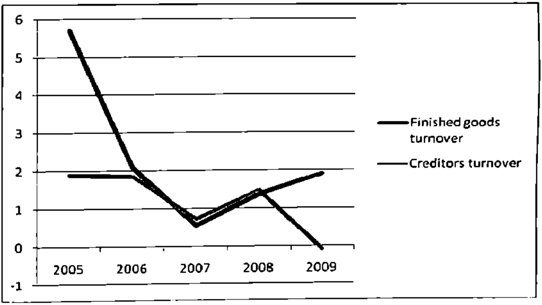


Figure 5: SBI Capital Markets Ltd.



Observations:

- As shown in Fig. 1, finished goods turnover has been highest in 2009 for INDBANK Merchant Banking Services Ltd. The line diagram shows that it has started increasing since 2008. Likewise, creditors' turnover has also been highest in 2009, and has increased in 2006, but fallen in 2007 and thereafter started rising from 2008.

- As shown in Fig. 2 for CANBANK Financial Services Ltd., finished goods turnover has been highest in 2008 but has fallen in 2006 and 2009, whereas creditors' turnover has been highest in 2005, but dropped significantly in 2006, and hovered around the same level up to 2009.

- As shown in Fig. 3, finished goods turnover has been highest in 2005 for IDBI Capital Market Services Ltd. The line diagram shows that it has fallen in 2006 and 2007, but increased in 2008 and has again fallen in 2009. On the other hand, creditors' turnover has been highest in 2008 with a rise and a fall between 2005 and 2007, and again a fall in 2009.

- In case of ICICI Securities Ltd. in Fig. 4, finished goods turnover has been highest in 2007, but has fallen in 2006 from 2005, increased in 2007 and again started decreasing in 2008 and 2009. Creditors' turnover has been highest in 2007, though low over the study period. It increased from 2005 but again decreased up to 2009.

- For SBI Capital Markets Ltd. in Fig. 5, finished goods turnover has been highest in 2005, but had a steep fall up to 2007 and increased marginally in 2008 and 2009. Creditors' turnover has also been highest in 2005. The line diagram shows that it has an alternate rise and fall since 2005 and has become negative in 2009.

Liquidity ratios (times)

Time-series analysis of selected merchant banks considers two components of Liquidity Ratios (in times) i.e., Quick Ratio & Current Ratio.

Figure 6: INDBANK Merchant Banking Services Ltd.

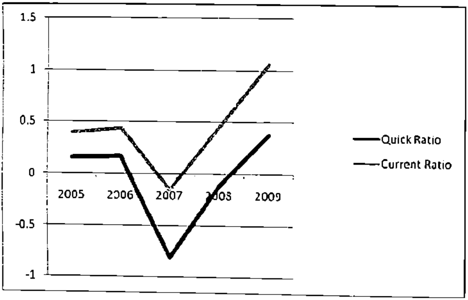


Figure 7: CANBANK Financial Services Ltd.

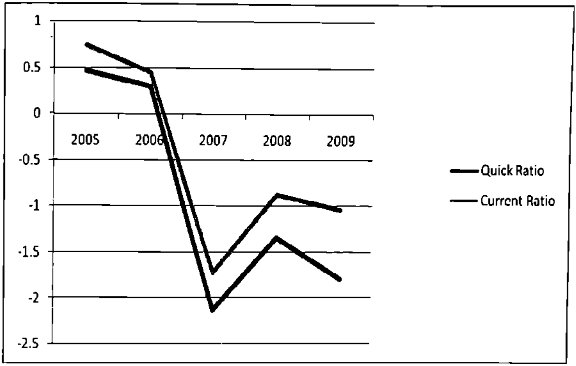


Figure 8: IDBI Capital Market Services Ltd.

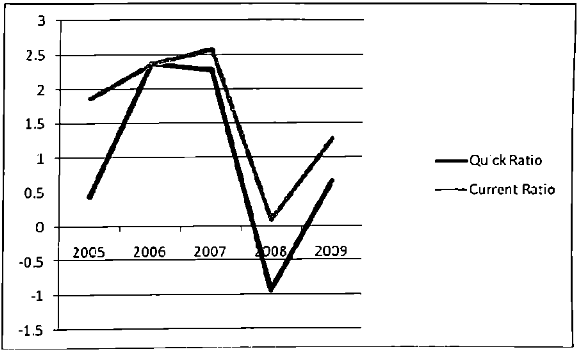


Figure 9 : ICICI Securities Ltd.

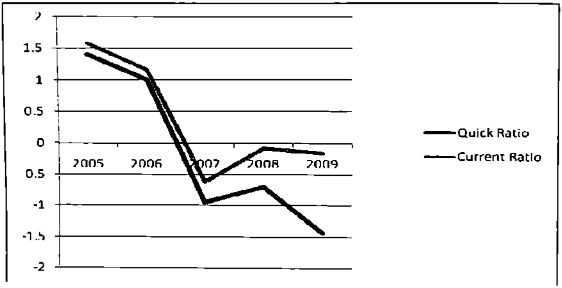
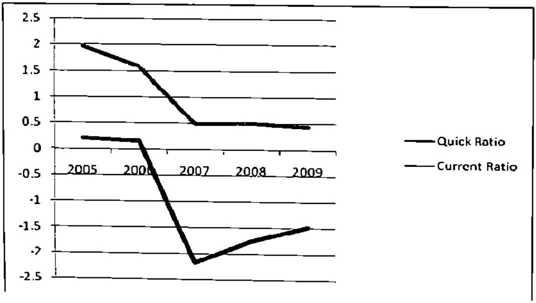


Figure 10 : SBI Capital Markets Ltd.



Observations:

- As shown in Fig. 6 on INDBANK Merchant Banking Services Ltd., both Quick Ratio and Current Ratio have behaved in a similar pattern and became highest in 2009. The line diagram shows that Quick Ratio has been more negative between the years 2006 to 2008 than Current Ratio.

- As shown in Fig. 7 for CANBANK, Quick Ratio as well as Current Ratio have been positive and highest in 2005 and thereafter became negative in all the last three years (2007-2009).
- In case of IDBI in Fig. 8, Quick Ratio has been highest in 2006, after rising from the level in 2005, but has fallen thereafter and has become negative in 2008, though again risen in 2009. Current Ratio has been highest in 2007 gradually rising from 2005, and thereafter reflected a similar trend as that of Quick Ratio.
- As shown for ICICI Securities in Fig. 9, Quick Ratio as well as Current ratio have been highest in 2005, reflected a fall and a similar trend thereafter, and have become negative in the last three years.
- As shown in Fig. 10 for SBI Capital Markets, Quick Ratio has been low in all the years of the study period and even became negative in the last three years whereas Current Ratio has been higher than Quick Ratio and became highest in 2005 but the curve is downward sloping thereafter.

Return ratios (%)

For time series analysis of each selected bank over the study period, two components of Return ratios (%) i.e., Profit before Interest and Tax (PBIT) / Average Total Assets and Profit after Tax (PAT) / Average Gross Fixed Asset (excluding revaluation and WIP) are selected.

Figure 11: INDBANK Merchant Banking Services Ltd.

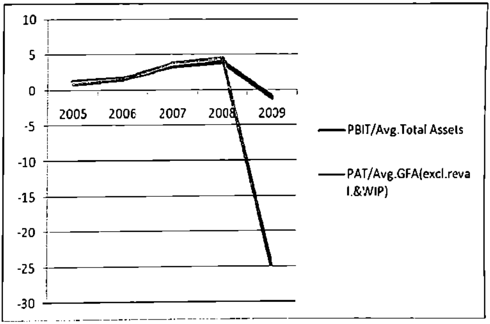


Figure 12: CANBANK Financial Services Ltd.

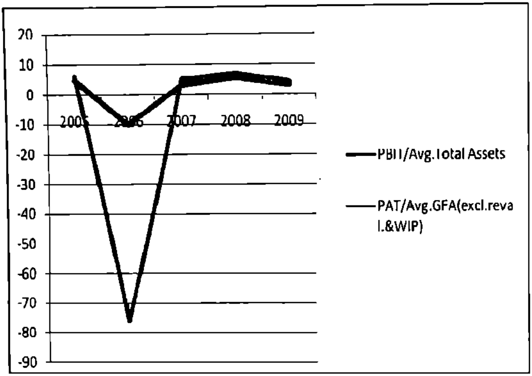


Figure 13: IDBI Capital Market Services Ltd.

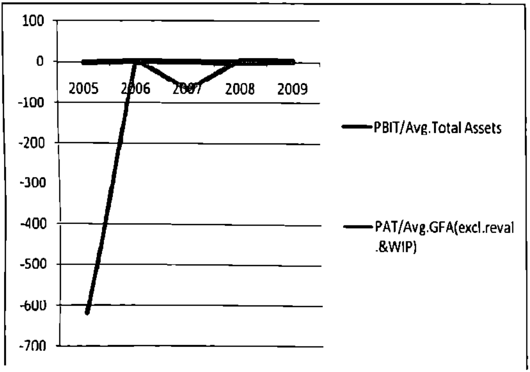


Figure 14: ICICI Securities Ltd.

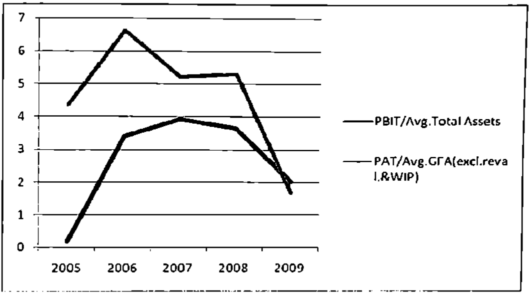
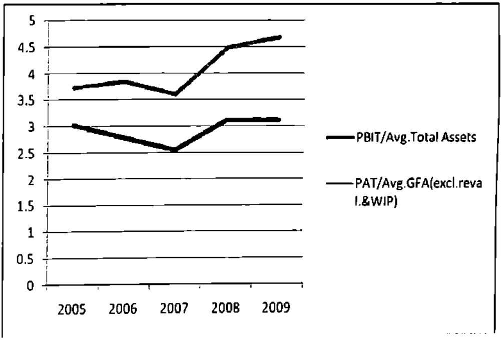


Figure 15: SBI Capital Markets Ltd.



Observations:

- As shown in Fig. 11 for INDBANK, PBIT/ Average Total Assets has been highest in 2008. The line diagram shows that it has increased from 2005 and has become highest in 2008 but has fallen thereafter and became negative in 2009. PAT / Average Gross

Fixed Asset (excluding revaluation and WIP) has been highest in 2008 after hovering around the same level as that of PBIT/Average Total Assets since 2005. The line diagram shows that PAT/Average GFA had a steep fall and became negative in 2009.

- As shown for CANBANK in Fig. 12, PBIT/ Average Total Assets has fallen steeply from 2005 and became negative in 2006. Thereafter it has risen in 2007 and became highest in 2008 and slightly decreased in 2009. PAT/ Average GFA has been mostly positive and highest in 2008, though it has been negative in 2006. However it slightly decreased in 2009.
- Fig. 13 for IDBI Capital Market shows that both the ratios have been significantly low and negative at times. PBIT/ Average Total Assets has been negative in 2005, though increased in 2006, and hovered around the same level in 2007, 2008 and 2009. PAT/Average GFA has shown a steep rise from a negative value in 2005, and thereafter has fallen again in 2007 and risen slightly in 2008 and 2009.
- As shown in Fig. 14 for ICICI Securities, PBIT/ Average Total Assets has been highest in 2007 but started falling thereafter whereas PAT/ Average GFA has been highest in 2006, and thereafter started decreasing from 2007.
- As shown for SBI Capital Markets in Fig. 15, PBIT/ Average Total Assets has been highest in 2008, though it has fallen in 2007. It has almost remained the same in 2009 as that in 2008. PAT/ Average GFA has been highest in 2009, and has mostly risen except a fall in 2007.

Cross-Sectional Analysis

In this form of analysis, the graphical representation in the form of bar diagrams portray the relative performance of the five banks with respect to each of the individual three ratio categories for each of the financial years from 2005 to 2009. The same two component ratios for each ratio category, as are used in time-series analysis, have been considered for such cross-sectional analysis. However, only the bar charts for the years 2005 and 2009 are shown for the sake of volume, and a summary analysis for all the years has been made.

Turnover ratios (times)

For cross-sectional analysis of each year over the study period, finished goods turnover and creditors turnover are plotted.

Figure 16: For the year 2005

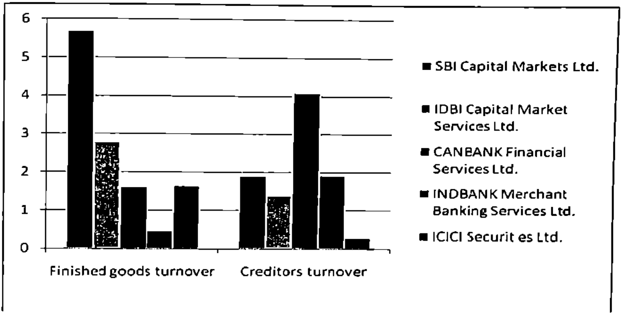
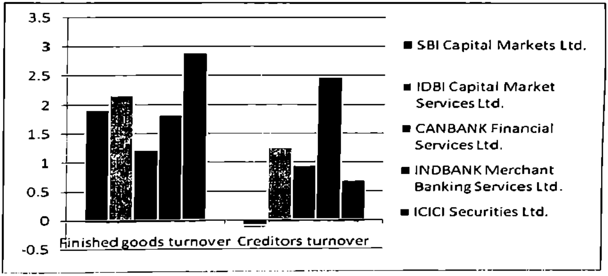


Figure 17: For the year 2009



Observations:

- As shown in Fig. 16, SBI Capital Markets Ltd. has the highest value in respect of finished goods turnover while CANBANK Financial Services Ltd. has taken the highest value in respect of creditor's turnover in comparison to the other four banks in 2005.

- As shown in Fig. 17, finished goods turnover is highest for ICICI Securities Ltd. while creditors' turnover is highest for INDBANK Merchant Banking Services Ltd. In 2009.

Liquidity ratios (times)

The following figures plot quick ratio and current ratio as components of liquidity ratios.

Figure 18: For the year 2005

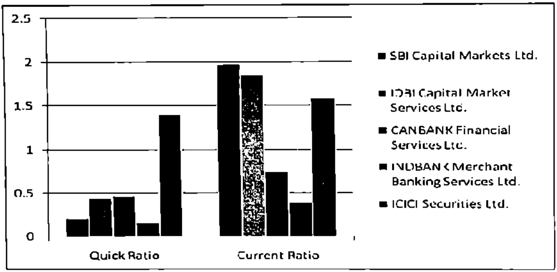
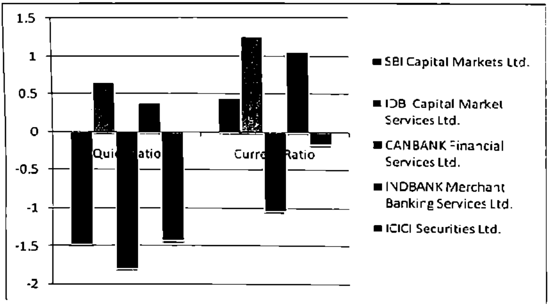


Figure 19: For the year 2009



Observations:

- As shown in Fig. 18, both the liquidity ratios, Quick ratio and Current ratio are positive for all banks in 2005. In case of Quick ratio, ICICI Securities Ltd. has been a better performer in comparison to the other four banks, whereas in case of Current ratio SBI Capital Markets Ltd. has been better.
- As shown in Fig. 19, Quick ratio is positive and highest for IDBI Capital Market Services Ltd. and INDBANK Merchant Banking Services Ltd. also has a positive value in 2009. In case of Current ratio, IDBI Capital Market Services Ltd., SBI Capital Markets Ltd. and INDBANK Merchant Banking Services Ltd. have positive values while IDBI Capital Market Services Ltd. has the highest value.

Return ratios (%)

For cross-sectional analysis of each year over the study period, the two components of return ratios - PBIT/ Average Total Assets and PAT/ Average GFA are plotted below.

Figure 20: For the year 2005

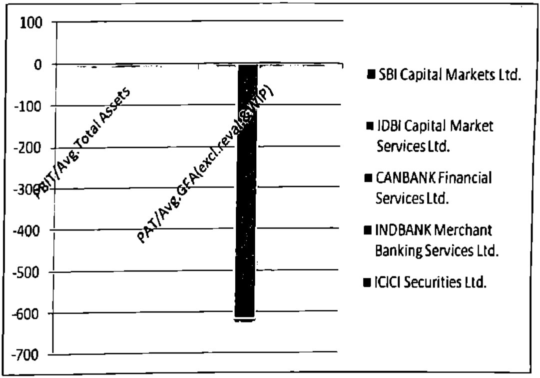
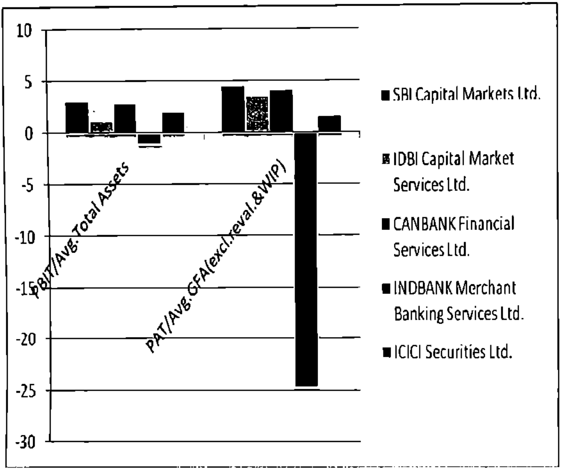


Figure 21: For the year 2009



Observations:

- As shown in Fig.20, all the banks have low values of PBIT/ Average Total Assets, while IDBI Capital Market Services Ltd. has a negative value in 2005. In respect of PAT/ Average GFA, again all the banks have low values with CANBANK Financial Services Ltd. having a higher value than other banks, while IDBI Capital Market Services Ltd. having a negative value.
- As shown in Fig.21, SBI Capital Markets Ltd. has a higher value in comparison to the other four banks in respect of PBIT/ Average Total Assets and PAT/ Average GFA in 2009, while INDBANK Merchant Banking Services Ltd. has a negative value for both the ratios.

Summary of Findings of Cross-sectional Analysis:-

Likewise, the cross-sectional analysis of the charts plotted for the years 2006, 2007 and 2008 are summarized in the table below :

Table 1: Summary of Cross-sectional analysis

Ratio Categories	2006	2007	2008
Turnover (times)	IDBI Capital Market Services Ltd. is highest with respect to Finished goods turnover whereas INDBANK Merchant Banking Services Ltd. has taken the highest value with respect to Creditors turnover.	ICICI Securities Ltd. has emerged as the best performer in respect of Finished goods turnover whereas INDBANK Merchant Banking Services Ltd. has performed better in case of Creditors turnover.	In respect of Finished goods turnover, CANBANK Financial Services Ltd. is the highest, though Creditors turnover is highest for INDBANK Merchant Banking Services Ltd.
Liquidity (times)	IDBI Capital Market Services Ltd. has clearly outperformed the other four banks.	Quick and Current ratios are the highest for IDBI Capital Market Services Ltd.	None of the sample banks has performed well in respect of Quick ratio. Whereas, SBI Capital Markets Ltd. has the highest value in case of Current ratio.
Return (%)	ICICI Securities Ltd. has a higher value.	ICICI Securities Ltd. has a higher value in comparison to the other four banks.	CANBANK Financial Services Ltd. has the highest value.

On an overall basis, CANBANK Financial Services Ltd. has performed well among all the sampled banks with respect to both cross-sectional analysis and time-series analysis. However, in respect of time series analysis, SBI Capital Markets Ltd. has emerged the second best performer while in case of cross-sectional analysis, both SBI Capital Markets Ltd. and IDBI Capital Market Services Ltd. have shown second best performance.

6. Conclusion

Merchant Banking in India was at its best during 1985-1992 when there were many new public issues on offer. But still some challenges are faced by merchant bankers such as SEBI guideline has restricted their operations to issue management and portfolio management only to some extent. So their scope of work is rather limited. Besides, poor new issues market in India has dried up the business of the merchant bankers. It is expected that coming years will be the best time for merchant bankers as many new issues are likely to come up.

The present study however suffers from the following limitations. Due to constraints in availability of data on financial parameters of merchant banks operating in India, the study is based on five selected merchant banks. Since the study concentrates only on a comparison of performance over the years (i.e. time-series analysis) and on relative performance (i.e. cross-sectional analysis) of select merchant banks in India, the causes of superlative or underperformance of such selected banks have not been investigated.

In spite of the above limitations, the present study assumes significance. One of the principal objectives of merchant banking is to enhance the shareholders' wealth by providing valuable advice on financial matters to the company. Accordingly, it can be said that financial performance of merchant bankers indirectly influences prosperity of companies. With this end in view, the present study has made an honest attempt to make a comparative analysis of performance of individual merchant banks with respect to three ratio categories over five years in the study period.

There are other aspects of merchant banking that can be researched. As for example, it has been mentioned that issue-management is one of the important service rendered by the merchant bankers. So an empirical study can be carried out to examine the procedure of issue management of merchant banks in different countries. The merchant banking operations in different countries vary depending upon the regulations implemented by the regulators of the country in which it is domiciled. Keeping in view the cross comparison among different countries, an effort can also be made to probe into the fact whether the convergence of merchant banking practices is possible.

'Private equity investing', regarded as 'Buyout investing' or 'Venture investing', taken up by many merchant banking financial institutions can be selected as a topic of research. Private equity investors make investments directly into private companies or conduct buyouts of public and private companies. The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time.

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