MERGERS AND ACQUISITIONS IN THE INDIAN FINANCIAL SECTOR SINCE ECONOMIC REFORMS: AN EMPIRICAL EXPLORATION OF DETERMINANTS AND EFFECTS

Priya Bhalla[1]

1. Introduction

The economic reforms and the associated change in policy framework brought in due to liberalization, globalization and deregulation increased competition and facilitated a global spurt in Merger and Acquisition (*M&A*) activities. An emerging economy, like India, also did not remain untouched and witnessed a flurry of consolidations especially in the financial services sector.

The present study goes beyond the existing studies and utilizes advanced econometric techniques to *ex-ante* identify the entities that are likely to be acquirers or targets and then estimate the *ex-post* performance of firms across different financial products, comprising all the commercial and co-operative banks, financial institutions and non-banking financial companies. Furthermore, such a deeper understanding of consolidation activity in the financial sector enables assessing the differential performance resulting from the heterogeneity of participating firms in different types of *M&A*.

Specifically, the objectives of the study are as follows:

- To analyze the trends of *M&A* in various sectors with special focus on the financial sector in India;
- Complete characterization of *M&A* occurring within financial sector of India for the period 1995-96 to 2011-12;
- To identify the distinctive characteristics of acquirers and targets in financial sector and to distinguish them from non-participants in *M&A;*
- To analyze the short, medium and long term impact of *M&A* on the performance of firms in the financial sector; and
- To examine the technical efficiency of the financial entities in the pre- and post-*M&A* period.

[1]Assistant Professor, Moti Lal Nehru College (E), University of Delhi. This is an abstract of the doctoral thesis which was submitted at Department of Business Economics, University of Delhi under the supervision of Dr. Aradhana Aggarwal and Dr. Ananya G. Dastidar.

2. Data

Since no single data source provides the requisite information on *M&A*, therefore, the following available sources are compiled to create an exclusive dataset on *M&A* in Indian financial sector during 1995-96 to 2011-12: Mergers & Acquisitions database compiled by Centre for Monitoring Indian Economy (CMIE); Prowess database compiled by CMIE; Company News and Notes (CNN), a publication by Department of Company Affairs (DCA); Securities and Exchange Board of India (SEBI) and several other sources such as Capitaline, Emerging Market Information Services (EMIS), annual reports and websites of individual companies, financial newspapers, RBI, Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) and other websites containing information on *M&A* announcements.

The present study deals with both the pre- and post-*M&A* evaluation of financial entities. For this purpose, the data on financial variables is compiled for more than 300 entities in the financial sector that have engaged in 208 *M&A* transactions during the period 1995-96 to 2011-12. The inclusion of all *M&A* within the financial sector yields a rich and heterogeneous sample of firms involving different kinds of entities (banks & non-banks, private & public Ltd., listed & non-listed, young & old, etc.). Further, to control for industry and economy wide changes, a random sample of non-participating firms has also been included. The present study provides a comprehensive overview of different types of *M&A* prevalent in financial services industry. Further, the present study goes beyond existing studies and utilizes rigorous econometric techniques to ex-ante identify the entities that are likely to be acquirers or targets and then estimate the ex-post performance of firms in the short, medium and long term across entire gamut of financial products.

3. Empirical Analysis

3.1 Trends and Patterns of *M&A*

This study focuses on emerging trends in *M&A* activities in India, underscoring the role of the country in worldwide patterns of *M&A*. Although *M&A* activity in India has been modest relative to advanced economies, nevertheless, it picked momentum after economic reforms, especially after the mid 1990s. There has been a dominance of certain sectors such as pharmaceuticals and financial services in *M&A* activity. Several studies have found that mergers may occur in waves, i.e., periods of intense merger activity may be followed by low merger activity. While the merger waves are well documented in advanced countries such as

US, UK and Europe, there are hardly any studies that attempt to identify these waves in Indian financial sector. Accordingly, the present study identifies the presence of merger waves in the Indian financial sector. Based on the temporal pattern of *M&A* activity, three distinct phases may be identified: pre-growth period (1995-96 to 2002-03), growth (2003-04 to 2007-08) and slowdown in *M&A* (post 2008).

3.2 Characteristics of Acquirers and Targets Prior to *M&A*

Specifically, the study intends to identify the distinctive characteristics of acquirers and acquired entities and distinguishes them from non-participants in the pre-*M&A* period using binomial and multinomial logit estimations. An analysis of firms in the pre-*M&A* period reveals that acquirers are bigger in size compared to targets while targets are bigger compared to non-participants. The joining together of big acquirers and targets has significant implications on India's financial stability calling for effective regulation. Further, the acquirers are more likely to be listed entities and repeatedly engaged in *M&A*. In addition, firm specific factors (such as firm size) rather than economy-wide characteristics (such as GDP growth) appear to be more relevant factors in explaining the probability of *M&A*.

3.3 Performance of Acquirers Post-*M&A*

The motives of *M&A* may range from improvement in the efficiency, profitability, growth and diversification, tax benefits, increasing market power, or managerial interests. Overall, the findings from regression analysis reveal that *M&A* may increase the size of the acquiring firms. Moreover, while most studies have been critical of efficiency implications of *M&A*, the present study finds evidence of efficiency improvement in acquirers in the short term, albeit weak. The dynamic ex-post performance analysis reveals that there has been a deterioration of capital, liquidity and asset quality (short, medium and long term) and increase in profits and size of the acquirers. At the same time, it is observed that acquirers in cross-border *M&A* find an increase in profitability, efficiency and size as well as a worsening of asset quality. The decline in asset quality puts the financial system at the risk of financial contagion. This calls for closer and continuous regulation and oversight of financial conglomerates growing rapidly in size, especially through *M&A*.

3.4 Evaluation of Technical Efficiency: Pre- and Post-M&A

In order to establish robustness of the findings, the role of technical efficiency in these financial entities is explored using the technique of Stochastic Distance Function, especially suited for multi-product firms like financial entities. In addition, the role of environmental variables in explaining technical efficiency has been investigated in single step estimation. In the pre-*M&A* period, no significant differences among acquirers and targets can be discerned. However, in the post-*M&A* period, the acquirers demonstrate higher efficiency relative to other firms. This indicates that the acquirers in the Indian financial sector are likely to derive positive benefits in technical efficiency consequent to *M&A*. However, the finding has not been consistent in all models based on accounting ratios.

4. Conclusion

In sum, the present study has provided an in-depth analysis of *M&A* in Indian financial sector incorporating widely different aspects. This is one of the first analytical studies to provide such a vast and comprehensive coverage of the entire gamut of *M&A* transactions that arise amongst the entities belonging to financial sector of India. In addition, the existing studies in *M&A* literature have simply classified firms as acquirer, target or non-participant without accounting for their long term strategic behaviour in *M&A*. The present study, however, captures the dynamic *M&A* activity of the firms by following these firms for a long period of time. The emergence of big global financial conglomerates has been one of the most noticeable finding of the study. This has substantial implications on the financial stability of the economy, especially due to the rising importance of the unregulated shadow banks. The increase in size consequent to *M&A* suggests that there could be an increase in market power of these firms. These firms could misuse this power by restricting credit to small borrowers or certain sectors, raising concerns on effective antitrust or competition policy. The increase in size also supports the managerial interests that may be directly linked to larger size.