Post-Merger Profitability: A Case of Royal Bank of Scotland (RBS)

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Abstract

In this study, I have used accounting ratios to analyze the financial performance of Royal Bank of Scotland (RBS) in Pakistan after merger. I have analyzed their financial statements for four years (2006-2009) by using 20 vital ratios. In spite of certain limitations, accounting ratios are still considered as a convenient and reliable analytical tool. Ratio analysis, being a time-tested technique, is most frequently employed in all financial decision-making processes. The results show that the financial performance of RBS in the areas of profitability, liquidity, assets management, leverage, and cash flows has been quite satisfactory before the merger deal. It means that merger deal fails to improve the financial performance of the bank.

Keywords: RBS, profitability, merger, financial performance, accounting ratios, decision-making

Introduction

In today's globalize economy, mergers and acquisitions (M&A) are being increasingly used the world over for improving competitiveness of companies through gaining greater market share, broadening the portfolio to reduce business risk, for entering new markets and geographies, and capitalizing on economies of scale etc. *Merger* is the combination of two or more entities through a purchase acquisition or pooling of interests, it is different from consolidation as there is no new entity is created from merger. The motives behind mergers and acquisitions are economy of scale, economy of scope, increase market share and revenues, taxation, synergy, geographical and other diversification. Due to these reasons banks merged with one another or targeted by acquiring bank.Recently, the Pakistani financial sector and the entire economy has been the focus both in the business circles and in the media, in terms of exceptional challenges being faced. Regulatory measures are being taken at both micro level as well as the macro economic level in order to improve the future condition of the different sectors which are under financial pressure or under financial crises. In order to overcome these financial crises, many mergers and acquisitions take place. This increase of mergers and acquisitions will change the entire structure of financial industry with the objective of making sector sound and decrease risks attached to financial industry.

In recent years, number of academic studies in industrial economics and company finance has measured the profitability of companies before and after merger. Sometimes their aim has been access the gain from merger to particular group of wealth-holders, such as the acquirer equity owners and at other times the exercise has been directed at accessing the impact of merger on efficiency, often as part of a discussion of whether government should foster or inhibit merger. Investment decisions are directly related to the financial factors. Investors and financial analysts use ratio analysis in order to evaluate the financial position of the organization. This tool is used to know about the company that whether it is profitable or not, it has enough money to pay its bills, the firm is doing better this year than it was last year, it is doing better or worse than its competitors in the same industry, the business is paying its share of tax, it is using its assets efficiently, it has a gearing problem, the value of the company has increased and the shareholders are satisfied with the rate of return on their investment or not. To answers to the above questions, data was collected from the financial statements.

In order to study the diversification effect of Mergers on merged bank's profitability or failure. I have reviewed the past era researches related to the topic. I have done the literature review of the different research articles in order to analyze & extract the prolific results. Rhoades (1993) talked about the impact of merger in banking industry on efficiency and profitability considering both the domestic and cross border mergers. This article discussed the cost and profit efficiency analysis of 33 bank-to-bank merger which shows that the most of the domestic mergers improves the cost efficiency and little improvement of profit efficiency whereas little improvement in the profit efficiency and no improvement in the cost of efficiency in the cross border mergers. Resti (1998) explore the effects of merger on performance, target markets and the merged banks. This article also measure the extra efficiency derived from the comparison with a benchmark. Merged banks seems to have increased their efficiency in the years after the merger and it is true when the deal of merger of two banks operating on the same local markets and when the size of the new bank is not so big.

Moreover this article states that the mergers between two equally sized banks increase the efficiency as well as the profits. Altunbas & Ibanez (2004) have observed the impact of strategic similarities between bidders and targets on post-merger financial performance. This article shows that on average, bank mergers in European Union resulted in improved return on capital. They ran the empirical analysis by using an extensive sample of individual bank mergers which, in turn, was linked to individual bank accounting information. Results from the descriptive analysis showed that the overall statistical picture is that of large, generally more efficient banks merging with relatively smaller and better-capitalized institutions with more diversified sources of income. They found that there are improvements in performance after the merger has taken place particularly in the case of cross-border mergers. In terms of the impact of strategic relatedness on performance, the overall results showed that broad similarities among merging partners were conducive to an improved performance, although there are important differences between domestic and cross-border mergers and across strategic dimensions. Vennet (1996) talked about effects of merger and acquisition on performance of the banks.

He highlighted various techniques to estimate the treatment effects of banks mergers on performance. This article provide evidence in favor of the view that there are positive and long lasting effects of banks merger and acquisition on the banks performance and the society as well especially it totally improves the cost efficiency of the banks.The finding from this research also suggests that the pre-merger effects are likely to occur in terms of the higher cost efficiency before the merger. But the small size banks enjoy the cost benefits more than the large size banks. Fixler & Zieschang (1993) illustrate the determinants of cost efficiencies of banks mergers. For this purpose the methodology is used to estimate pre and post merger cost efficiencies of 348 mergers.From this article it is proved that the cost efficiency improves in the most of the banks mergers but the gains were smaller. Efficiency improved only when both the partners of the merger were cost inefficient and it also suggest that the cost savings is depend more on the opportunities facing management than the management quality. Badreldin & Kalhoefer (2009) have measured the performance of Egyptian banks that have undergone mergers or acquisitions during the period 2002-2007. This is done by calculating their return on equity using the Basic ROE Scheme in order to determine the degree of success of banking reforms in strengthening and consolidating the Egyptian banking sector.

The findings indicate that not all banks that have undergone deals of mergers or acquisitions have shown significant improvements in performance and return on equity when compared to their performance before the deals.Furthermore, extensive analysis was performed yielding the same results. It was concluded that mergers and acquisitions have not had a clear effect on the profitability of banks in the Egyptian banking sector. They were only found to have minor positive effects on the credit risk position. These findings do not support the current process of financial consolidation and banking reforms observed in Egypt, and provide weak evidence to support their constructive role in improved bank profitability and economic restructure. Sufian (2004) talked about the efficiency effect of mergers and acquisitions of banks in Malaysia. For this purpose Malaysian commercial banks were taken to analyze the technical efficiencies during the merger year, pre-and post merger period. Our results suggest that during the sample period, Malaysian banks have exhibit a commendable overall efficiency level of 95.9% suggesting minimal input waste of 4.1%. We also found that scale inefficiencies dominate pure technical efficiency in Malaysian banking post merger

After analyzing Malaysian commercial banks we found that the post merger program was successful and results suggest that the small size Malaysian banks have benefited the most from merger program but large Malaysian banks are still facing scale inefficiency problem from merger program. Mylonidis & Kelnikola (2005) explore the merging activities in Greek banking system. The main purpose is to access the financial performance of the recent mergers and acquisitions in Greek banking system. The methodology used to access the financial performance is the Operating Performance (OP) of the banks by observing the pre- and post-merger financial performance of the Greek banks. Profits, operating efficiency and labor productivity ratios of the bidding and targets banks do not improve after merger but when compared with the ratios of non-merging banks then we conclude that the merger program has a positive impact on banks' operating performance but it has a negative impact on liquidity measure. Burki & Ahmad (2008) talked about the impact of changes in governance of banks on the performance of commercial banks in Pakistan's banking sector from 1991 to 2005. The findings of this paper suggest that, in general, financial reforms improve banking sector performance. The winners from the governance change are the privatized banks and private banks selected for M&A, whose post-governance-change efficiency levels have enabled them to exploit new profit making opportunities. Healy, Palepu & Ruback (1992) talked about the impact of mergers and amalgamation on performance of companies.

Theoretically it is assumed that mergers improve the performance due to increased market power, synergy impact and other qualitative and quantitative factors. After evaluating the performance of 40 Indian companies, this study shows that Indian companies are no different than the companies in other part of the world and mergers were failed to contribute positively in the performance improvement. Weinberg (2007) discussed the price effects of horizontal mergers. Most of the mergers resulted in increased prices for both the rival firms and merging parties at least in short-run. There is also some evidence from the past studies that the product price increases after mergers are announced.Ashton & Pham talked about the efficiency and price effects of horizontal bank mergers. This study provides an empirical assessment of the efficiency and interest rate changes occurring 61 UK retail bank mergers. Key findings of the work include the general efficiency enhancing influence of UK bank mergers and the limited effect of merger on retail interest rates. Furthermore, different banking products appear to be influenced differently by mergers. Mantravadi & Reddy (2008) explore the impact of mergers on the operating performance of acquiring corporate in different industries, by examining some pre-merger and post-merger financial ratios.

The results suggest that there are minor variations in terms of impact on operating performance following mergers, in different industries in India. In particular, mergers seem to have had a slightly positive impact on profitability of firms in the banking and finance industry. Choi & Harmatuck (2006) discussed the post operating performance of constructive mergers of United States of America. This study examines the operating performances after the merger during the past two decades (1980-2002). After merger the cash flow returns was not improved significantly. Secondly, the operating performance was slightly improved due to increased in the size of the firm. Martikainen & Ankelo (1991) discussed a critical review of the theoretical and empirical basis of four central areas of financial ratio analysis. The research areas reviewed are the functional form of the financial ratios, distributional characteristics of financial ratios, classification of financial ratios, and the estimation of the internal rate of return from financial statements. It is observed that it is typical of financial ratio analysis research that there are several unexpectedly distinct lines with research traditions of their own. A common feature of all the areas of financial ratio analysis research seems to be that while significant regularities can be observed, they are not necessarily stable across the different ratios, industries, and time periods. This leaves much space for the development of a more robust theoretical basis and for further empirical research. Hviid & Prendergast (1993) discussed the merger failure and profitability. The focus of this study was the profitability of bidder and target.

They illustrate how an unsuccessful bid may increase the profits of the target but reduce the profits of the bidding firm relative to the profits of the firms before the merger deal. Fridolfsson & Stennek (2006) talked about reduction in profits and increase in share price after merger deal. They provide a possible explanation for the empirical puzzle that mergers often reduce profits, but raise share prices. If being an 'insider' is better than being an 'outsider', firms may merge to preempt their partner merging with a rival. The insiders' stock market value is increased, since the risk of becoming an outsider is eliminated. Pinches, Mingo & Caruthers (1973) apply factor analysis to classify 51 log-transformed financial ratios of 221 firms for four cross sections six years apart. They identify seven factors, return on investment (ROI), capital intensiveness, inventory intensiveness, financial leverage, receivables intensiveness, short-term liquidity, and cash position. These factors explain 78-92% (depending on the year) of the total variance of the 51 financial ratios. Moreover, the correlations for the factor loadings and the differential R-factor analysis indicate that the ratio patterns are reasonably stable over time (Mingo and Caruthers, 1975). After the thorough review, it has been noticed that the mergers and acquisition of the banks in all the countries of the world increases or improves the cost efficiency and also improves little profit efficiency which is beneficial for the society and economy as well because merger contributes profits to the banks as well as the economy but the banking policies and other market conditions can change the whole scenario.

Methodology

The aim of the study is to answer "*Does merger of the banks improves the profitability?*" It also explores the effects of merger on profitability of the bank by using different accounting ratios. For this purpose, RBS is chosen as sample Company for this study. Profitability ratios, liquidity ratios, market value ratios have been considered as the most reliable and efficient ratios to check the profitability of the companies. Financial ratios can be an important tool for business owners and managers to measure their progress toward reaching company goals, as well as toward competing with larger companies within an industry. Management makes extensive use of these accounting ratios to access the performance of the organization. These accounting ratios also help in making rational decisions and future planning for the betterment of the organization.

Sample

The sample of study includes financial reports of Royal Bank of Scotland (RBS) and ABN AMRO Bank.

Hypothesis

In order to fulfill the main objective of the study, following hypothesis has been formulated.

Null Hypothesis: On the basis of accounting ratios analysis, profitability of the Royal Bank of Scotland (RBS) improves after merger. (Post-merger profitability)

Alternative Hypothesis: Profitability of merged bank (RBS) does not improve after merger.

Instrument

In order to analyze and calculate the liquidity performance and operating performance of the bank, secondary data (2006-09) audited financial statements including Balance Sheets, Profit and Loss Accounts and Cash Flow Statements of RBS and ABN AMRO Bank would be used.

Data Analysis

Financial data from Balance Sheets, Profit and Loss Accounts and Cash Flow Statements of the two companies for four years (2006-2009) have been used to calculate and analyze the accounting ratios which is also known as performance indicators.

Financial Ratios

Financial ratios are the useful indicator of the firm's performance and financial health. Most of the ratios are computed by the financial statements (Balance Sheet, P/L A/C and Cash flow Statement) of the companies. Ratios convert these financial statements in such a simple and understandable way that a normal person can easily understand the financial position of that particular organization. These ratios are used to analyze the trends within the same industry and usage of these ratios also helps us to compare the results with competitors and industry benchmarks. As a highly important analytical tool financial ratios help the financial analysts to take decisions in order to improve the liquidity, profitability, financial structure, leverage and interest coverage etc. When the financial ratio figures over a period of time are compared, then this method sometimes called inter-company or trend analysis. By using this method the owner of the business can identify trends, good and bad, and then adjust accordingly. The owner also compares the ratios with other industries in order to look at the industry trends (a cross company analysis).

In this study following performance indicators have been used:

Liquidity Ratios.

Profitability Ratios.

Solvency / Leverage Ratios.

Return on Investment Ratios.

Market Stock Ratios.

Results and discussion

With the help of financial data available in audited statements of ABN AMRO and RBS Four years accounting ratios have been computed as per formulae before merger (ABN AMRO) and after merger (RBS). These accounting ratios including liquidity ratios, profitability ratios, return on investment ratios, solvency ratios and market stock ratios have been computed. The averages of these ratios are shown in Table 5.1-5.5. The below given tables are the comparison of ratios before and after merger deal to show the post merger financial health of the bank.

Table 5.1 LIQUIDITY RATIOS COMPARISON

Liquidity Ratios	Before Merger (ABN AMRO) (Averages)	After merger (RBS) (Averages)	ABN AMRO (Status)	RBS (Status)
Current Ratio	0.82	0.52	Better	-
Acid Test Ratio	1.36	0.53	Better	-
Cash Ratio	0.67	0.38	Better	-
Working Capital	(3,407,954)	(9,658,680)	Better	-

The above table related to the averages of the liquidity ratios and there comparison between the averages before merger and averages after merger in order to show the average result with regards to the liquidity position of the bank. From the calculation it is clear that bank is in better condition before merger in terms of liquidity. All the average ratios are better before the merger of banks. So ABN AMRO status was better than RBS in terms of liquidity.

Table 5.2 PROFITABILITY RATIOS COMPARISON

Profitability Ratios	Before Merger (ABN AMRO) (Averages)	After merger (RBS) (Averages)	ABN AMRO (Status)	RBS (Status)
Return on Assets	0.20%	-0.96%	Better	-
Return on Equity	-3.44%	-10.17%	Better	
Gross Profit Margin	2.33%	3.86%	-	Better
Net Profit Margin	0.26%	-1.14%	Better	-
Pre-Tax Profit Margin	0.96%	-1.52%	Better	-
Operating Profit Margin	3.67%	2.05%	Better	-
Management Rate of Return	3.71%	2.13%	Better	-

After liquidity comparison the profitability ratios comparison is also an important measure of firm's financial position. The above table is the clear indication that the bank's profitability is better before merger because of the reason that out of 7 average ratios 6 are in favor of ABN AMRO.

Table 5.3 SOLVENCY/LEVERAGE RATIOS COMPARISON

Solvency Ratios	Before Merger (ABN AMRO) (Averages)	After merger (RBS) (Averages)	ABN AMRO (Status)	RBS (Status)
Total Debts to Equity	17.80	10.68	-	Better
Proprietary Ratio	0.06	0.09	-	Better
Interest Coverage Ratio	-0.24	0.20	-	Better
Debt Ratio	0.94	0.91	-	Better
Long Term Debts to Equity	14.36	7.55	-	Better

As you that firms are financed by both debt and equity. These ratios determine firm's solvency position. In terms of bank's long-term debt paying ability, the status of RBS improves after merger deal which means that bank's long-term paying capacity improves after merger.

Table 5.4 RETURNS ON INVESTMENT RATIOS COMPARISON

Return on Investment Ratios	Before Merger (ABN AMRO) (Averages)	After merger (RBS) (Averages)	ABN AMRO (Status)	RBS (Status)
Return on Capital Employed	1.46%	-2.50%	Better	-
Return on Shareholders Funds	7.24%	-13.56%	Better	-

The above ratios comparison is about the average gains on total capital invested in business and average gains on the total funds employed by the shareholders/stakeholders of the firm. The bank gain better returns before merger deal because the returns are higher than cost of capital. The status of ABN AMRO was better than RBS due the reason that the earnings available to the stakeholders of the bank were higher before merger.

Table 5.5 MARKET STOCK RATIOS COMPARISON

Market Stock Ratios	Before Merger (ABN AMRO) (Averages)	After merger (RBS) (Averages)	ABN AMRO (Status)	RBS (Status)
Earning Per Share	0.31	-0.59	Better	-
Earning Yield Ratio	0.05	0.01	Better	-

The above table clearly indicates the averages of the market value of the stock of the bank. These ratios help the investors in making right investment decisions. The status regarding stock market, the bank was in better condition before merger with RBS.

Conclusion

This study is conducted to find the profitability of the RBS after merger deal. In all, 20 ratios using financial statements have been calculated. Instead of comparing individual ratios their averages have been compared. Out of 20 ratios, numbers of favorable ratios before and after merger are as under:

Table 6.1 Total Ratios Comparison

Group of Ratios	Total Number of Ratios Calculated	Number of Favorable Ratios Before Merger	Number of Favorable Ratios After Merger
Liquidity Ratios	4	4	-
Profitability Ratios	7	6	1
Solvency Ratios	5	-	5
Return on Investment Ratios	2	2	-
Market Stock Ratios	2	2	-
Total	20	14	06

Out of 20 ratios, score for the 'better' ratios after merger is just 6 (i.e. 30% only). From an investor's point of view, the role of these accounting ratios is enough to find out the profitability of the any firm. Recently, FAYSAL BANK has acquired 99.37 % stake in Royal Bank of Scotland (RBS) Group's Pakistan unit for Rs. 4.298 billion (Rs. 2.50 per share) because bank was not creating its value and continuously incur losses after merger. Although mergers play an imperative role in boosting up the financial sector of the country. But in this case it is concluded that the merger of RBS fails to pull up its profitability. From the ratio analysis it is proved that the RBS merger proves to be a failure in banking history.

Limitations

There are certain limitations or weaknesses of this research study:

The main limitation of this research study is the non availability of financial data before 2006. The data before 2006 is not available on internet and stock exchange (KSE) which are the utmost sources of information regarding financial data. Another limitation is that it only talks about the diversification effect of banks mergers and acquisition it totally ignores the other corporate sectors of the economy. There must be an impact of possible differences in accounting methods adopted by these foreign banks. Customer Service Officer of RBS does not give the full information about the bank's merger. Although this study explain the efficiency effects of banks mergers and acquisition but it did not cover the other effects of mergers and acquisition in banking sector like cognizable efficiencies effect which are related to specific mergers in banking sector.

Recommendations

There are certain suggestions for this research study:

RBS has to follow same policies and incentive plans that central bank have to maintain in order to boost up the profits in Pakistan's banking sector.

This bank has to use same reporting standards like IFRS and IAS.

The bank has to minimize the cost of capital in order to maximize the returns.

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