

IMPACT OF M & AS ON SHAREHOLDERS' WEALTH: EVIDENCE FROM THE INDIAN BANKING SECTOR

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ABSTRACT

A burgeoning economy, financial sector reform, rising foreign investment, favorable regulatory climate and demographic profile has lead to India becoming one of the fastest growing banking markets in the world. This paper presents an empirical investigation of various banks M & As in India. The investigation contains an assessment of value addition to shareholders of Banks in India after merger by using three value added metrics, like EVA, MVA and RONW. This paper also assesses the motives of merger of the banks by using various financial ratios both in pre- and post-merger periods. Four public merged banks (SBI, BOB, OBC, PNB) and Four private merged banks (ICICI Bank, Indusind Bank, HDFC and IDBI Bank Ltd.) are taken for this study.

KEYWORDS: Mergers, Acquisitions, Shareholders Value, EVA, MVA, RONW.

INTRODUCTION

The prime objective of a bank is to grow profitably. The growth can be achieved by expanding or enlarging the capacity in terms of numbers of customers and branches. Basically the external growth can be achieved by acquisition of existing banks. So, M & As are quite important form of external growth which gives value addition to shareholders. The Merger and Acquisition activity has been noticeable not only in developed market but also in emerging markets like India. In the past few years, Indian Banking sector has followed the trends in consolidation amongst other banks and financial institutions through Mergers and Acquisitions (M&A).

The basic question of M & As is whether Mergers and Acquisitions create value and enhance the financial performance of Merged firms. The 'Value added' is described as 'the wealth created by the reporting entity by its own and its employees' efforts and comprises salaries and wages and other perquisites, tax, dividend and net profit. When considering value added, we are assessing the wealth that has been created by an entity in its entirely all its machines, labour, management and capital. So, value added is an important measurement to assess the financial performance of an entity. It shows the net value or wealth created by the organization during a specific period of time. Specifically in the Indian economy, "Maximizing Shareholders Value" is a popular slogan in the minds of the corporate people.

In the Indian Banking sector, there are number of banks that have enter into merger and acquisition agreements to survive in the globalize market. In India, more banks and financial institutions going for horizontal mergers. The major motives of bank mergers is growth, economy of large scale, profitability, tax exemption and risk reductions.

LITERATURE REVIEW

Bannister and Belkaoui(1991), suggested that value added was worthy of consideration as a tool for the evaluation of the performance of a company as it showed a clear dominance over both earnings and cash flow information.

Belkaoui (1993), studied about relative and incremental information content of value added, earnings and cash flows and by using earnings valuation model, concluded that value added information can supply some explanatory power beyond that provided earnings or cash flow measures.

Belkaoui (1999), examined the substitution of net value added for earnings in equity valuation. In this study, he tested descriptive validity of the Feltham and Ohlson (1995) model and concluded that when net value added is substitute as a measure of wealth for earnings, the resulting accounting valuation model is better descriptive than the conventional Feltham-Ohlson (1995).

Machiraju (2002), Commercial banks have lent money to some corporates that have picked up PSUs through the divestment route. But, the mode of financing is more of balance-sheet financing and not the leveraged buy-out financing. Indian banks have traditionally carried out either balance-sheet or asset based financing and the loan decisions are usually taken on the basis of the cash flows of the corporates, and they have never financed an LBO, where 70% or more of the take-over funding comes from borrowed funds.

Sterner (2004), explained the merger motives in terms of synergies and deterrents. External synergies, real or pecuniary, may make the merged company worth more than the sum of the pre-merger companies. This may be due to economies of large-scale production and/or creation of monopoly power.

Dwyer (2006), presents information on the impact of Mergers and Acquisitions (M&As) on the employees of both the companies. He finds that managers and research and development engineers are exposed to a culture shocks as a result of M&As. Quoting Alan Fitzgerald, a marketing and business consultant who spent five years as a M&A specialist at BT's IT offshoot, Syntegra, he says in many take-overs the bidder wants the customer base, or to enter new markets, develop new products, or enter new geographies. He further says that according to Fitzgerald achieving these goals depend on people already there.

CONCEPT OF ECONOMIC VALUE ADDED

Economic Value Added (EVA) has been redefined and popularized by US based Stern Stewart & company. EVA is a modified version of residual income concept. It is considered as the most accurate measure of the economic performance of the company. It attempts to resolve the need for a performance measure that is highly correlated to the shareholder wealth and responsive to the actions of the company's managers. Shareholder value is considered as an essential measure of the corporate performance. According to Peter Drucker, Management Guru ' EVA is a vital measure that reflects all the dimensions by which management can increase value. It is the best financial measure than any other measure in capturing true economic profit of an enterprise. The

shareholders return is not the usual dividend payment, but it is the return commensurate with the risk involved on investment made by them in the business. It the earnings that the shareholders could have earned by investing in similar risk profile investments, i.e. they have to be paid their opportunity cost of capital. The basic different between EVA and Accounting model is that, the accounting model does not acknowledge the cost of equity.

The current demand for adopting EVA is based on a simple idea, i.e. you can not know whether your company is creating value for your shareholders until you subtract cost of capital from income. If EVA is positive, the company is adding value for its shareholders and if the EVA is negative, the company destroying value even if positive or growing earning per share (EPS) and return on invested capital (ROIC). So, EVA is the most accurate measure of economic performance of the company and be calculated at the level of divisions and product lines.

$$\begin{aligned} \text{EVA} &= \text{NOPAT} - \text{COST OF CAPITAL EMPLOYED} \\ &= \text{NOPAT} - \text{WACC} * \text{CE} \end{aligned}$$

Where

NOPAT : Net operating profit after taxes but before financing costs,

WACC : Weighted average cost of capital, and

CE : Capital employed

STEPS IN COMPUTING EVA

1. Calculation of NOPAT
2. Computation of Economic Capital (Capital Employed)
3. Computation of WACC (Weighted Average Cost of Capital)
 - a. Cost of Equity
 - b. Cost of Debt
4. Computation of EVA

NOPAT = (profit after taxes + Non- recurring expenses + Revenue expenses on R&D + Interest expenses + Goodwill written off + provision for taxes) - Non recurring income – R&D amortization - Cash operating taxes.

CASH OPERATING TAXES = (Provision for taxes + Tax benefit of non-recurring expenses + Tax benefit of interest – Tax on non-recurring incomes).

CAPITAL EMPLOYED = Net fixed Assets + Investments + Current Assets - (NIBCLs + Miscellaneous expenses not written of + Intangible Assets) - (Cumulative non-recurring losses + Capitalized Expenses on R&D + Gross Goodwill) - Revaluation Reserve - Cumulative non-recurring gains.

NON- INTEREST BEARING CURRENT LIABILITIES (NIBCLS) = The financing costs associated with paying suppliers and employees with some delay are already included in the cost of goods sold. Hence , these costs are excluded from capital.

COST OF EQUITY (USING CAPM) = $R_f + \beta (R_m - R_f)$

Where :

R_f : Risk free return. Normally 364 days Treasury Bill rates are considered as risk free. Here I am taken 4.55 as Risk free rate of return.

β : Beta is the risk – free coefficient which measures the volatility of a given script of a company with respect to volatility of markets. Mathematically, beta is the statistical measure of volatility. It is calculated as covariance of daily return on the stock market indices and the return on daily share prices of a particular company, divided by variance of return on daily stock market indices. In my research, I used the Regression formula for the calculation of Beta (β).

$$\text{Beta } (\beta) = \frac{N \sum xy - (\sum x)(\sum y)}{N \sum x^2 - (\sum x)^2}$$

Where X = Monthly closing return on the stock market indices (NSE).

Y = Monthly closing return on share prices of particular company.

N = no. of months in a year.

R_m = The market expected rate of return. It is normally given as growth rate of market index.

$$R_m = \frac{\text{Today 's index} - \text{Yesterday 's index}}{\text{Yesterday 's index}}$$

$$\text{Cost of Capital} = \frac{\text{Interest Expenses } (1 - \text{Tax})}{\text{Total Borrowings}}$$

MARKET VALUE ADDED

Another important measure that assesses the value addition to shareholders or not, i.e. Market Value Added (MVA). If the total market value of the company of a company is more than the amount of capital invested in it, the company managed to create shareholder value. But, if market value is less than capital invested, the company has destroyed shareholder value. The difference between the company's market value and book value is called Market Value Added (MVA).

Market Value Added (MVA) = Market Value of the company – Capital invested in the company (Book value of equity)

MARKET VALUE: For a public listed company, it is calculated as the number of shares outstanding *the share price + book value of Debts (since the market value of debt is generally not available).

CAPITAL INVESTED: It is the book value of investments in the business made up of debt and equity.

RETURN ON NET WORTH (ROWN)

Return on Net Worth is relatively narrow measure of shareholder value creation metrics. It is calculated the Net profit after tax divided by the shareholders wealth in the company, i.e. paid up capital plus free reserves. This measure nets out the pre- committed payment obligations to creditors and wealth created for the shareholders.

$$\text{Return on Net Worth} = \frac{\text{Profit after Tax (PAT)}}{\text{NetWorth}}$$

OBJECTIVES OF THE STUDY

The following objectives have been formulated in the study

1. To evaluate the post-merger performance of the merged companies using the value added metrics of corporate performance such as Economic Value Added, Market Value Added and Return on Net worth.
2. To evaluate the pre- and post-merger financial performance of merged companies and examined the influence of motives' variables on mergers such as : profit maximization, Market share, Growth, Tax consideration, Risk reduction (Diversification) and Leverage.

TEST OF NULL HYPOTHESIS

To accomplish the objectives of the study, the following null hypothesis have been developed for empirical testing :

Ho1 Mergers and Acquisitions do not result in value addition to shareholders.

Ho2 There is no difference between pre- and post-merger performance of merged companies.

SOURCES OF DATA

The study is based on the investigation of eight merged banks, (four public and four private) listed on the National Stock Exchange (NSE). The study is based on secondary data collected from the corporate databases of Cygnus and CMIE and some other financial data used for this

study has been mainly taken from NSE and respective Annual Reports of the Banks. We hope, it is an authentic source of information and has the advantage of greater availability and consistency of data.

RESEARCH METHOD

The impact of merger in terms of value addition can be studied by using three value added metrics (EVA, MVA and RONW). The empirical results of effects of mergers on the financial performance both pre- and post-merger period of all merged banks have been computed in terms of sixteen ratios, t-test, Mean We have focused upon three pre-merger and three post-merger years. Year (0) has been excluded from the analysis. Year (0) figures are affected by one-time merger costs incurred during that year, making it difficult to compare them with the results for other years.

EMPIRICAL FINDINGS

First, the value of all the three value added metrics namely, EVA (Economic Value Added), MVA (Market Value Added) and RONW (Return on Net Worth) has been computed for each bank and the results are presented in a table.

TABLE 1

Sl.No	Name of the Merged Banks	EVACE			RONW(%)			MVACE		
		Year-1	Year-2	Year-3	Year-1	Year-2	Year-3	Year-1	Year-2	Year-3
1	State Bank of India	-2	-0.69	-1.06	15.95	14.51	13.72	251.09	215.08	507.64
2	Bank of Baroda	2.15	5.67	-4.26	14.26	17.62	18.85	-17.31	1.49	-36.55
3	Indusind Bank	-0.88	2.72	2.24	24.52	4.25	6.15	37.29	15.73	-29.68
4	The Oriental Bank of Commerce	-3.78	0.94	-1.91	10.47	10.04	5.77	0.03	-3.31	0.62
5	Punjab National Bank	1.01	-2.24	0.56	14.4	15.35	14.28	23.29	2.54	28.63

6	ICICI Bank Ltd.	-0.77	-1.05	0.008	17.39	20.44	15.98	145.59	153.91	23.15
7	HDFC Bank	-1.58	2.97	-	13.83	15.33	-	92.53	-4.98	-
8	IDBI Bank Ltd.	-0.54	0.37	-0.27	8.8	7.59	8.27	25.25	-68.85	59.71

OBSERVATIONS

EVA

Economic Value Added (EVA) computed for all the banks for three post-merger period to see whether shareholders value has increased in each passing year after the merger. From the above table it is clear that, State Bank of India loses value addition in post-merger period, Bank of Baroda added some value in second post-merger period and in third year it shows negative value addition. Indusind Bank shows value addition in post-merger period, The Oriental Bank of Commerce reveals positive value addition in second year but negative in third year, Punjab National Bank shows negative value addition in second year and very negligible value addition in third year. ICICI bank indicates negative value addition in first two post-merger period and less value addition in third year. HDFC bank added value addition in post-merger period but IDBI bank Ltd. added value in second post-merger and value erosion in third post-merger period.

From the above analysis, except Indusind bank and HDFC bank, all the other banks erosion economic value in post-merger period.

RONW

Return on Net Worth (RONW) computed all the banks for three post-merger period. State Bank of India and The Oriental Bank of Commerce continuous decreases value addition in post-merger period. Bank of Baroda and HDFC bank added value in post-merger period and no impact of merger for other banks on post-merger period because the results shows that, some banks decreases in second year and increases in third year and some banks shows increase in second year and decrease in third year.

MVA

An analysis of Market Value Added (MVA), the State Bank of India and Indusind bank continuously erosion the value in post-merger period but all other sample merged banks has no impact on value addition or value lost on post-merger period because some banks shows value erosion on first two post-merger year and again positive value addition on last year. Again some banks are showing value addition on first two years and value erosion on third year.

After the analysis of EVA, RONW and MVA, it is clear that, Mergers and Acquisitions do not result in value addition to shareholders which satisfied the first hypothesis.

EFFECT OF MERGERS ON FINANCIAL PERFORMANCE OF ACQUIRING BANKS BEFORE AND AFTER MERGER

Effect of mergers on the financial performance of acquiring banks (in terms of sixteen financial variables) before and after the merger has been examined with the help of Student's t-test and the pairs being number of firms registered increase and decrease in the value of financial variables in the two time periods before the merger and after the merger. The pairs with the same result are dropped from the analysis. Since the given number of matched pairs in this case is less than twenty-five (i.e. small sample), t-test is calculated and the probabilities observed are compared with the desired level of significance (0.01 and 0.05) to accept or reject the null hypothesis.

TABLE - 2

PERFORMANCE EVALUATION: PRE- AND POST-MERGER PERIOD

Sl. No	Name of the Merged Bank		PBT/Net	PBIT/Cap	PAT/NW	PAT/N o.of	Op. Exp/	DIV/E PS
			Sales	Employed		Shares	Net Sales	
1	State Bank of India	Pre-merger	0.24	0.2	17.41	5.84	0.86	0.16
		Post-merger	0.12	0.14	14.73	27.67	0.9	0.19
2	Bank of Baroda	Pre-merger	0.26	0.25	16.11	2.62	0.31	0.38
		Post-merger	0.24	0.27	16.91	2.59	0.28	0.39
3	Indusind Bank	Pre-merger	0.2	0.26	22.94	3.58	0.76	0.64
		Post-merger	0.09	0.24	11.64	3.43	0.87	0.29
4	The Oriental Bank of Commerce	Pre-merger	0.21	0.29	23.9	25.12	0.69	0.19

		Post-merger	0.1	0.15	8.76	19.11	0.77	0.27
5	Punjab National Bank	Pre-merger	0.24	0.3	21.85	33.17	0.73	0.11
		Post-merger	0.23	0.19	14.68	43.4	0.75	0.15
6	ICICI Bank Ltd.	Pre-merger	0.13	0.06	8.94	2.55	0.98	0.25
		post-merger	0.17	0.11	17.94	2.45	0.96	0.39
7	HDFC Bank	Pre-merger	0.28	0.16	16.3	2.83	0.7	0.23
		post-merger	0.23	0.22	9.72	3.63	0.77	0.22
8	IDBI Bank Ltd.	Pre-merger	0.07	0.11	6.73	0.66	0.72	0.31
		post-merger	0.11	0.07	8.22	0.88	0.77	0.21

TABLE - 2

PERFORMANCE EVALUATION: PRE- AND POST-MERGER PERIOD

Sl.No	Name of the Company		Tax/P BT	CA/C L	D/E	EBIT/Int.	F.Asset/NW	Mkt Price/ EPS
1	State Bank of India	Pre-merger	0.33	3.76	0.81	1.27	0.13	4.57
		Post-merger	0.32	2.01	2.02	3.61	0.09	12.55
2	Bank of Baroda	Pre-merger	0.36	12.22	0.53	1.17	0.19	6.5

		Post-merger	0.3	10.16	0.55	1.4	0.16	1.85
3	Indusind Bank	Pre-merger	0.2	10.98	1.21	1.19	0.24	5.27
		Post-merger	0.27	6.13	1.64	1.15	0.37	25.57
4	The Oriental Bank of Commerce	Pre-merger	0.34	8.85	0.55	1.35	0.07	2.7
		Post-merger	0.4	7.19	0.67	1.22	0.07	11.53
5	Punjab National Bank	Pre-merger	0.31	4.75	0.72	1.49	0.22	13.88
		Post-merger	0.22	10.69	1.04	1.39	0.11	13.67
6	ICICI Bank Ltd.	Pre-merger	0.27	6.16	5.47	1.24	1.79	10.58
		Post-merger	0.12	4.68	5.46	1.23	0.47	8.42
7	HDFC Bank	Pre-merger	0.33	2.06	1.47	1.64	0.16	31.19
		Post-merger	0.44	2.93	1.07	1.42	0.11	25.94
8	IDBI Bank Ltd.	Pre-merger	0.24	1.63	3.95	2.14	0.22	22.97
		Post-merger	0.25	3.43	6.88	12.64	0.38	11.83

Table - 2

PERFORMANCE EVALUATION: PRE- AND POST-MERGER PERIOD

Sl.No	Name of the Company		Own sale/ Ind. Sale	Growth EBITD A	Growth Net Asset	Risk Reduction
1	State Bank of India	Pre-merger	0.47	0.02	0.21	14.33
		Post-merger	0.37	0.98	0.38	27.46
2	Bank of Baroda	Pre-merger	0.09	0.39	0.02	43.64
		Post-merger	0.09	0.38	0.03	172.11
3	Indusind Bank	Pre-merger	0.01	0.63	0.31	59.89
		Post-merger	0.01	0.55	0.84	39.6
4	The Oriental Bank of Commerce	Pre-merger	0.05	0.03	0.47	85.28
		Post-merger	0.05	0.8	0.87	32.71
5	Punjab National Bank	Pre-merger	0.12	0.31	0.52	217.06
		Post-merger	0.11	0.71	0.88	147.3
6	ICICI Bank Ltd.	Pre-merger	0.15	0.15	0.24	72.5
		Post-merger	0.15	0.14	0.74	93.94
7	HDFC Bank	Pre-merger	0.05	0.74	1.14	176.48
		Post-merger	0.09	4.19	17.98	446.96
8	IDBI Bank Ltd.	Pre-merger	0.09	0.07	0.64	244.64

		Post-merger	0.06	0.4	0.93	246.4
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TABLE 3

PERFORMANCE EVALUATION: PRE- AND POST-MERGER PERIOD

	Dimensions of Financial Performance	Students' t-test	Increased after Merger		Decreased after Merger		Same result	
			No. of Co.	(%)	No. of Co.	(%)	No. of Co.	(%)
1	Profit Measurement(PM)	1.826	02	25%	06	75%	-	-
2	PBIT	1.173	03	37.5%	05	62.5%	-	-
3	PAT/NW	1.445	03	37.5%	05	62.5%	-	-
4	PAT/No of share(EPS)	-1.251	04	50%	04	50%	-	-
5	Expenses ratio	-2.337	06	75%	02	25%	-	-
6	Market Share	.878	01	12.5%	03	37.5%	4	50%
7	Dividend/EPS	.792	05	62.5%	03	37.5%		
8	Tax/PBT	.240*	04	50%	04	50%		
9	CA/CL	.347**	03	37.5%	05	62.5%	-	-
10	D/E ratio	-1.543	06	75%	02	25%		
11	EBIT/ Int.	-1.199	03	37.5%	05	62.5%	-	-
12	FA/NW	.931	02	25%	05	62.5%	1	12.5%
13	MP/EPS(P/E ratio)	-.482**	03	37.5%	05	62.5%	-	-
14	Growth EBITDA	-1.766	05	62.5%	03	37.5%	-	-
15	Growth net total assets	-1.156	08	100%	-	-	-	-
16	Risk reduction	-0.925	05	62.5%	03	37.5%	-	-

TABLE 4

PERFORMANCE EVALUATION: COMPARATIVE STATISTICS OF PRE- AND POST-MERGER PERIOD

Sl.No	Dimensions of financial performance	Mean (Pre-merger)	Mean(Post-merger)	t-values
1	Profit Measurement(PM)	0.21	0.16	1.826
2	PBIT	0.20	0.17	1.173
3	PAT/NW	16.77	12.82	1.445
4	PAT/No of share(EPS)	9.55	12.89	-1.251
5	Expenses ratio	0.72	0.66	-2.337
6	Market Share	0.13	0.15	.878
7	Dividend/EPS	0.28	0.24	.792
8	Tax/PBT	0.29	0.11	.240*
9	CA/CL	6.30	5.90	.347**
10	D/E ratio	1.84	2.42	-1.543
11	EBIT/ Int.	1.44	3.01	-1.199
12	FA/NW	0.38	0.22	.931
13	MP/EPS(P/E ratio)	12.21	11.92	-.482**
14	Growth EBITDA	0.29	1.02	-1.766
15	Growth net total assets	0.44	2.83	-1.156
16	Risk reduction	1.14	1.51	-0.925

Total No. of firms (N) = 08

* denotes significance at 5% level.

** denotes significance at 1% level.

Note: The figures in parenthesis are estimated probabilities.

OBSERVATIONS

The results of the table reveal that, 75% of the acquiring banks in the sample registered a decline in profitability in post-merger period. However, only in case of dividend per share, 62.5% of the sample banks an increase. Only 25% of the firms have been able to economies on operating costs but 50% of these have reduced their post-merger effective rate of tax. Further, impact of growth through mergers has been significant with 100% of sample banks increase in terms of net total assets and 62.5% increase in EBITDA. Mergers' impact on diversification has been found to be significant with 62.5% of merged banks revealing increased variation in profits and thus increased risk through mergers.

The impact of mergers on the financial performance of merged banks before and after mergers has also been analyzed with the help of student's t-test by comparing the difference of means of all the financial variables for all the aggregate banks together. This t-test, based on t-distribution is considered an appropriate test for judging the significance of difference between the means of two samples (here, financial performance in pre-and post-merger period) when they are related. The value of test statistic 't' has been calculated from the sample data of specific level of significance for accepting or rejecting the null hypothesis.

As revealed from the table, some of the financial variables are significantly different in pre-and post-merger period at 1% level of significance. However, performance variables exhibit higher mean value in pre-merger period compared to post-merger period, indicating that, on an average, performance has declined in post-merger period. As shown by the table, t-values for performance dimensions like working capital, P/E ratio are shows significance difference between pre-merger and post-merger performance at 1% level of significance and only effective tax rate has registered significance difference in its pre- and post-merger values at 5% level of significance. The t-values of other dimensions are insignificant even though their means suggest significant difference.

To conclude, the null hypothesis that there is no significance difference between pre-merger and post-merger financial performance of merged firms has been rejected and alternate hypothesis that there is significant difference in their pre- and post-merger performance is accepted. However, in some cases, post-merger performance has improved but in most cases, it has been declined. Overall, these results indicate that mergers do not lead to improved post-merger performance since the most important motive of profitability has not been achieved.

CONCLUSIONS

The area of mergers and acquisitions has been extensively researched in many developed nations especially in US and UK. But now a day, in India some work has been done in this area. The present study has made an analysis of corporate mergers in India. However, M &As activity taking place in India is not limited to corporate mergers alone as there are number of other activities like takeovers, spin-offs, management buyouts, demergers, etc. In fact, internationally, the term mergers and acquisitions (M & As) is now used to cover all transactions relating to the sale and purchase of subsidiaries, divisions, brands, assets and entire company. Long-run success of mergers can be analyzed by taking a longer time period, say five to seven post-merger years.

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