M. Madhavi (India), R. Radhika (India)

Bank equities: the best choice of investments

Abstract

The effects of the Global financial crisis on the world economies including India are visible. The Indian stock markets are also experiencing the turmoil, which is resulting in the downfall of the indices, fall of prices and fall of the markets altogether. The markets are under the constant pressure of the recessionary and inflationary trends taking place in the economy. It is becoming increasingly difficult for the investors to realize profits; rather they are searching for ways to avoid losses in the current market scenario. In the backdrop of the crisis, the emphasis is back on the investments in reliable organizations, particularly banks. As far as the Indian stock markets are concerned, Banking & Non-Banking sectors have been playing a major role in promoting investments. Even though there are a number of private sector banks, public sector banks are dominating the financial system in our country. In the context of the importance attached to public sector banks, a study has been undertaken to evaluate the performance of the equities of these with leading private sector banks with the help of fundamental analysis. The study basically has considered Earnings Per Share (EPS), Dividends Per Share (DPS), and Price Earnings Ratio, which will provide the investor with a basic knowledge on the performance of the equities of these banks.

Keywords: banks, equities, earnings per share, dividend per share, price earnings ratio, fundamental analysis, company analysis, private sector banks, public sector banks.
JEL Classification: G3, G32, G320.

Introduction

The Indian banking sector has witnessed a significant development in the recent past with the entry of private banks and their focus on retail banking and convergence of services. The business models of the leading players are adapting to this impending change as banks are widening the spectrum of savings and products they offer. Eventually they have entered the equity markets also, to collect funds from the individual investors and disburse them to the needs of the corporate.

Banking in India is considered mature in terms of supply, product range and reach – even though the reach in rural India still remains a challenge for private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks of Asian region.

If prices of the stocks are based on investor expectations, then knowing what a security should sell for (i.e., fundamental analysis) becomes less important than knowing what other investors expect it to sell for. That's not to say that knowing what a security should sell for isn't important – it is. But there is usually a fairly strong consensus of a stock's future earnings that the average investor cannot disprove. Hence, knowing the underlying factors that influence stock prices is very important before choosing a security.

Fundamental analysis is a method of forecasting the future price movements of a financial instrument based on economic, political, environmental and other relevant factors and statistics that will affect the basic supply and demand of the financial instrument. While purchasing equities the investors depend on fundamental analysis as this provides an insight into the performance analysis of the concerned organizations.

About the study. Keeping in view the importance attached to the banking industry in India, and public faith in investments associated with this sector a study has been undertaken, with the help of fundamental analysis and with special reference to earnings per share, dividend per share, and price earnings of the banks. Fundamental analysis equips the investors with all necessary inputs in the form of information related to the Economy, Industry at the macro level and the Company in micro perspective. As Earnings Per Share (EPS), Dividend Per Share (DPS), and Price Earnings Ratio (P/E Ratio) provide an insight into the performance of the equities of the organizations, these have been taken for analyzing the equities.

The scope for analyzing the performance of the whole banking sector is very wide and it will not be possible to cover that under a single study. So, the authors have confined the present study to the fundamental analysis of 4 banks, which are the leading banks of India viz., Canara Bank, Bank of Baroda in the public sector and HDFC, ICICI, in the private sector. The study covers a period of five years from 2004 to 2008.

Type of the study. The research has been based on secondary data analysis. The study has been Exploratory as it aims at examining the secondary data for analyzing the previous researches that have been done in the area of fundamental analysis of stocks. The knowledge thus gained from this preliminary study forms the basis for the further detailed Descriptive research.

Sample design. The sample of the stocks for the purpose of collecting secondary data has been selected on the basis of Random Sampling. The stocks are chosen in an unbiased manner and each stock is chosen independent of the other stocks chosen.

Techniques. The following techniques have been incorporated to get a clear perspective of the performance of the banks, selected for the study.

Earning per Share: $EPS = \dfrac{EBIT\ (or)\ Net\ Worth}{No\ of\ shares\ outstanding}$

Dividend Per Share: $DPS = \dfrac{No\ of\ dividend\ paid}{No\ of\ shares}$

Price Earning ratio: $P/E = \dfrac{Market\ price\ of\ share}{Earning\ per\ Share}$

1. Conceptual framework of the study

1.1. Structure of banking industry in India. At present, India has 88 Scheduled Commercial Banks (SCBs), 27 Public Sector Banks (that is the Government of India holding a stake), 29 Private Banks (these do not have government stake; they may be publicly listed and traded on stock exchanges), 4 Local Area Banks and 31 Foreign banks along with Co-operative Banks.

1.1.1. Commercial banks. In the organized sector, initially commercial banks were set up in large numbers, mostly as corporate bodies with shareholding of private individuals. In the twentieth century a large number of smaller banks emerged in the country leading to a drift towards state ownership and control. Today the public sector is having a strong base of commercial banks, operating in India which falls under different sub categories on the basis of their ownership and control over management.

1.1.2. Public sector banks. Public sector banks emerged in India in three stages. Initially it was the conversion of the Imperial Bank of India into State Bank of India in 1955, followed by the taking over of the seven associated banks as its subsidiaries. Later taken place, the nationalization of 14 major commercial banks in 1969 and finally, the nationalization of 6 more commercial banks in 1980. Thus, there exist 27 banks in the public sector of the Indian banking industry.

1.1.3. Private banks. After the nationalization of the major banks in the private sector in 1969 and 1980, no new bank could be setup in India for about two decades, though there was no legal bar to that effect. The Narasimham Committee on financial sector reforms recommended the establishment of new banks of India. RBI thereafter issued guidelines for setting up of new private sector banks in India in January 1993. Eight private sector banks have been established including banks set up by financial institutions like IDBI, ICICI, and UTI etc. According to the guidelines of RBI, they have to work in a professional manner, so as to improve the image of commercial banking system.

1.1.4. Local area banks. These banks can be established as public limited companies in the private sector and can be promoted by individuals, companies, trusts and societies. The minimum paid up capital of such banks would be 5 crores with promoters' contribution of at least Rs. 2 crores. They are to be set up in district towns and the area of their operations would be limited to a maximum of 3 districts. At present, four local area banks are functional, one each in the states of Punjab, Gujarat, Maharashtra and Andhra Pradesh.

1.1.5. Foreign banks. Foreign commercial banks are the branches of banks incorporated in other countries and working in India. This segment was not as popular as that of other banking organizations in India. Due to the financial sector reforms, the entry of foreign banks into Indian financial sector has been facilitated and now these are also playing their role in the domestic banking operations to a considerable extent.

1.1.6. Cooperative banks. Besides the commercial banks in India, there exists another set of banking institutions called cooperative credit institutions. They undertake banking business both in urban and rural areas on the principle of cooperation. They have served a useful role in spreading the banking habit throughout the country.

1.2. Literature review. *1.2.1. Earnings per share.* Earnings are the amounts of profit that a company produces during a specific period, which is usually defined as a quarter (three calendar months) or a year. Earnings typically refer to after-tax net income. Ultimately, a business's earnings are the main determinant of its share price, because earnings and the circumstances relating to them can indicate whether the business will be profitable and successful in the long run. The portion of a company's profit is allocated to each of the outstanding common stocks, as equity shareholders are the owners of the organization. This proportion can be known through the calculation of the Earnings per Share. It can be represented by the formula

EPS = Net Worth of the Organization / No. of Outstanding Shares

While calculating, it is more accurate to use a weighted average number of shares outstanding over the reporting term, because the number of shares outstanding can change over time. However, data sources sometimes simplify the calculation by using the number of shares outstanding at the end of the period.

1.2.2. Dividends per share. The dividend per share is a simple formula that takes the total dividend payment and divides it by the total number of outstanding shares. The more shares that are outstanding, the fewer dividends per share can be captured. The dividend per share, or DPS, is usually declared every quarter at a meeting of the board of directors or shareholders. Most of the times, the dividend per share is made a matter of public record and could spur an increase in the stock's value, especially in the short term. The DPS can be calculated by the formula

DPS = Dividends Paid / Number of Shares outstanding

Dividends are very important to some shareholders, as it is one of the primary ways of making money in the stock market. In fact, some investors may buy a stock and hold onto it for a relatively short period of time just to take advantage of the dividend per share payment. Often, the dividend per share is a measure of a company's performance, simply because it indicates how profitable a company is over a quarter or year. Companies often compare the performance in each quarter to what it did in the same quarter the last year. This may also include a comparison of the dividend per share from the previous year.

1.2.3. Price to earnings. The P/E looks at the relationship between the stock price and the company's earnings. The P/E is the most popular metric of stock analysis, although it is far from the only one you should consider.

P/E = Stock Price / EPS

The P/E gives an idea of what the market is willing to pay for the company's earnings. The higher the P/E, the more the market is willing to pay for the company's earnings. Some investors read a high P/E as an overpriced stock and that may be the case, however, it can also indicate the market has high hopes for this stock's future and has bid up the price. A low P/E may indicate a "vote of no confidence" by the market or it could mean this is a sleeper that the market has overlooked. Known as value stocks, many investors made their fortunes spotting these "diamonds in the rough" before the rest of the market discovered their true worth.

2. Profiles of the banks under study

2.1. Canara bank. Founded as 'Canara Bank Hindu Permanent Fund' in 1906, by late Sri. Ammembal Subba Rao Pai, a philanthropist, this small seed blossomed into a limited company as 'Canara Bank Ltd.' in 1910 and became Canara Bank in 1969 after nationalization. Canara Bank has carved a niche for itself in providing IT-based services. With 100% computerization of the branches, the bank provides a wide array of services, such as, Networked ATMs, Anywhere Banking, Tele-banking, Remote Access Terminals Internet & Mobile Banking, Debit Card etc. For the year 2004-05, Canara Bank clocked the highest net profit (Rs. 1110 crores) among nationalized banks, with significant improvement in capital adequacy ratio (12.78%) and asset quality.

2.2. Bank of Baroda. Starting in 1908 from a small building in Baroda to its new hi-rise and hi-tech Baroda Corporate Center in Mumbai is a saga of vision, enterprise, financial prudence and corporate governance. The Group's principal activities are to provide banking and related services through 2,732 branches in India and 40 overseas branches. The services include accepting deposits, commercial and institutional credit, project finance, treasury, forex, investment and risk management. Bank of Baroda took the lead in shifting from manual operating systems to a computerized work environment. Today, the Bank has 1918 computerized branches, covering 70% of its network and 91.64% of its business. In 1995 the Bank raised Rs. 300 crores through a Bond issue. In 1996 the Bank tapped the capital market with an IPO of Rs. 850 crores.

2.3. Housing Development Finance Corporation Limited (HDFC). It was amongst the first to receive an 'in principle' approval from the Reserve Bank of India (RBI) to set up a bank in the private sector, as part of the RBI's liberalization of the Indian Banking Industry in 1994. The bank was incorporated in August 1994 in the name of 'HDFC Bank Limited', with its registered office in Mumbai, India. HDFC Bank commenced operations as a Scheduled Commercial Bank in January 1995.

The Bank's target market ranges from large, blue chip manufacturing companies in the Indian corporate to small & mid-sized corporate and agri-based businesses. For these customers, the Bank provides a wide range of commercial and transactional banking services, including working capital finance, trade services, transactional services, cash management, etc. The bank is also a leading provider of structured solutions, which combine cash management services with vendor and distributor finance for facilitating superior supply chain management for its corporate customers.

2.4. ICICI Bank. ICICI Bank is India's second-largest bank with total assets of Rs. 3,997.95 billion (US$ 100 billion) as of March 31, 2008 and profit after tax of Rs. 41.58 billion for the year ended March 31, 2008. ICICI Bank is the second amongst all the companies listed on the Indian stock exchanges in terms of free float market capitalization. The Bank has a network of about 1,308 branches and 3,950 ATMs in India and presence in 18 countries. ICICI Bank offers a wide range of banking products and financial services to corporate and retail customers through a variety of delivery channels and through its specialized subsidiaries and affiliates in the areas of investment banking, life and non-life insurance, venture capital and asset management.

ICICI Bank's equity shares are listed in India on Bombay Stock Exchange and the National Stock Exchange of India Limited and its American Depositary Receipts (ADRs) are listed on the New York Stock Exchange (NYSE). ICICI Bank offers a variety of cards to suit your different transactional needs. Our range includes credit cards, debit cards and prepaid cards. These cards offer you convenience for your financial transactions like cash withdrawal, shopping and travel. These cards are widely accepted both in India and abroad. Read on for details and features of each.

3. Observations of the study

As a part of the analysis, the Earnings Per Share, Dividend Per Share and Price Earnings of the selected banks have been taken and tabulated. They also have been presented in the form of a bar graph for the period of study. Following is the presentation of the results.

The following is the comprehensive presentation of the calculations related to EPS, DPS and P/E Ratio of the selected banks.

Table 1. EPS

Year	Canara Bank	Bank of Baroda	HDFC	ICICI
2004	35.41	35.55	25.58	35.51
2005	30.3	25.87	32.2	35.23
2006	36.3	25.75	41.34	35.56
2007	38.27	33.51	50.16	40.64
2008	42.32	45.78	52.53	42.56

Table 2. DPS

Year	Canara Bank	Bank of Baroda	HDFC	ICICI
2004	5	6.5	3.5	7.5
2005	5.5	5	4.5	8.5
2006	6.6	5.7	5.5	8.5
2007	7	6.9	7	10
2008	8	9.36	8.5	11

Table 3. P/E Ratio

Year	Canara Bank	Bank of Baroda	HDFC	ICICI
2004	5.1	7.1	30	28.1
2005	5.9	9.6	25	28.3
2006	4.9	9.7	19	22.4
2007	4.7	7.4	11	19.6
2008	4.2	5.8	9.5	18.7

Conclusion

In the public sector, Bank of Baroda is performing well when compared with Canara Bank and in the private sector, ICICI is performing better than HDFC. If we observe the overall trend in the EPS, DPS of the selected banks in the banking sector, they are showing an increasing trend during the period of study. But majority of the other industries like IT, realty and retail, which are hot favorites for investors in the stock markets have shown a decreasing trend in the time of crisis. This supports the fact that conservative investors can depend on public sector banks, wherein risk takers can go for private sector banks. The study reveals that the banks are able to maintain a profitable position as evident from the calculations of the earnings and dividends both in the public and private sectors. But when it has come to the price earnings, which always depend on the market price of the equity, all the banks are showing a decreasing trend. This indicates a clear decline in the market prices of the equities, as the EPS of all these banks are increasing, projecting an increase in the net worth of the organizations. This can be attributed to the global financial crisis, which has exercised its influence on almost all the world economies. Even though there is a crisis in all spheres of the economy, its impact on the Indian banking industry is negligible, thanks to the conservative policies of the government of India and the authorities of the central bank. Now, the situation is favorable to the small investors also, who always want to be a part of the Indian capital market. They can rely upon fundamental analyses, as the market based analysis may sometimes be misleading to them. In fact, a combination of fundamental analysis mixed with a reliable market data always will be a beneficial option for the investors, who don't want their investments to go in vain. Banking sector in India is providing the investors with all necessary information as per the regulations of the Reserve Bank of India that can be trusted upon. As the possibilities for providing wrong and unrealistic information are less with the Indian banking sector, investors can depend on these investments as the best choices of their portfolio.

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