Chapter 13

Financial Performance and Valuation of Indian Banks: David Cole Model

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ABSTRACT

The Indian banking sector is undergoing a phenomenal transformation through innovative business lines. The sustainability of the banks is characterized by superior performance, more prudent behavior in the finance and commerce industry. Keeping in view the diversification, valuing bank stocks is a cumbersome task. Reliability, transparency, corporate governance, Economic Value Added (EVA), Corporate Social Responsibility (CSR) are a recent buzz when ranking of the profitability of banks is to be considered by the investor. Operational efficiency, liquidity, solvency, profitability is to be weighed using metrics and evaluation of the sources and magnitude and performance of the banks. DuPont analysis/David Cole Method of bank groups comes to the rescue of the researcher to understand the profitability. The authors have evaluated sources and magnitude of performance, profitability and productivity of the listed Indian Banks. As a pilot study, data has been collected for the years 2007-2016 of three public and three private sector banks and statistical Chi-square tool has been applied to ROA, ROE and EM as variables.

INTRODUCTION

The financial sector is undergoing a turmoil with galloping Nonperforming assets, stressed assets and willful defaulters. Since the Banks and financial institutions enter into various scintillating markets/businesses to make immense profits and the pinnacle of various complex tools that they use for making such

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profits in relentless competition makes it very cumbersome for the evaluators to measure and analyse the performance of these institutions. The concern for evaluation is not just because of the demanding operations and the usage of complex tools but also because of the existence of various rules and regulations for each type of institutions that are present. Also there are numerous models developed by prestigious authors for the evaluation of performance which, at times, makes it difficult for the analyser to select one amongst the available.

Among these financial institutions, the most influential are the banks, of course, for obvious reasons. They cater to a large number of population in terms of providing employment as well as providing services. Banks play a dual role. They, as any other financial institution, provide their stakeholders with a high ROE. At the same time, other businesses proper because of the infrastructural base provided by banks. As a result, there is a lot of trust of economy on banks. However, the tragedies like Lehman brothers, Merrill Lynch AIG, Kingfisher fiasco, etc. has shaken the trust on the financial statements of banks from the economic point of view. However, it is said that Indian banks, both private and public sector banks, have not been affected majorly by the mishap. Nevertheless, the concern is not the impact; the topic of worry is the lost trust of the investors all over the globe in these chief institutions. A dispute also lies on which sector of banks are performing better. Is it the sector, which serves with the sole purpose of public serving i.e. the public sector banks? Alternatively, is it the sector, which aims at providing high ROE to its stakeholders i.e. the private sector banks?

To evaluate and validate this, the authors to check the performance of both the sector banks are using David Cole model here. This model uses a framework in the form of various ratios to enlighten the performance of banks and provide an in-depth knowledge of operations of banks for both incomes as well as expenditures. For this paper, the author has selected 6 banks, i.e. 3 private sector banks (ICICI, HDFC, AXIS) and 3 public sector (SBI, BOB and PNB) and then using the David Cole model have analyzed the banks performance on the basis of ratios suggested by the model.

David Cole Model

In 1972, David Cole introduced a methodology to access the worth of banking sector using ratio analysis. Du-Pont system of financial analysis was used as the basis and Cole adopted it in 1972. It takes reference from the return on equity model in order to determine the bank’s worthiness, which, in turn, helps in understanding the return on the risk taken. It provides insights into the profit in the banking sector in comparison to the risk taken. Ratios, used here, are a measure to understand the productivity of the two or more banking organizations introduced earlier.

David Cole Model considers ROA and Equity multiplier for concluding the ROE of any year, any company. It further disintegrates ROA into components like expense ratio, tax ratio, and asset utilization (AU).

ROE, Return on Equity, refers to the net income earned on the money invested in the firm by the stockholders. The money invested by the stockholders is the average total equity. It is the Net income before dividends being distributed. It is well quoted “the higher the return the better it is”, as with greater income, banks can increase their retention every year and also more returns gives a better impression in the eyes of the investors as with more returns provides the ability to give more cash dividends as well.

\[ \text{ROE} = \frac{\text{Net Income}}{\text{Average Total Equity}} \]