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Do Romanian Banking Institutions Create Shareholder Value?

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Abstract

This study aims at identifying the evolution of some of the key value based indicators in the case of Romanian listed banks. In particular we compute value based measures like Residual Income RI and Market Value Added MVA but also traditional measures like Earnings per Share EPS and Price to Earnings ratio PER in order to have a detailed view on the evolution of shareholder value creation in the banking industry for last seven years 2005-2011. As results suggest BRD represents the greater shareholder value creator in the case of the listed banks. On the other hand EBS is the greater value destroyer. The other listed banks TLV and BCC can be characterized as value preserver as they don't destroy nor create shareholder value.

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Keywords: banking performance,shareholder value, residual income, market value added, EPS, PER

1. Introduction

The concept of shareholder value creation reflects the fundamental principle of successful financial management: to maximize the market value of investor's wealth. As a result, the most successful investment or budgeting decision will reflect themselves in the growth of the market value of equity of the firm. Establishing market value or firm growth nevertheless implies the process of valuation: determining value and value drivers is essential considering the simple postulate of a sound investment: do not pay more for an asset than it's worth.

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Following Damodaran 2002, 2010a, 2010b three approaches to valuation can be identified: intrinsic valuation, relative valuation and contingent claim valuation. The intrinsic valuation elaborates on the principle that every asset that generates cash-flows is characterized by cash-flow *potential* and *risk*. The major criticism of this view relies upon the fact that when significant uncertainty about the future exists estimating the intrinsic value becomes difficult and pointless. In the case of relative valuation, the value of an asset is derived from the pricing of a 'comparable' assets, standardized using a common variable such as earnings, cash-flows, book value or revenues Damodaran, 2002:9. The result of this approach on valuation represents a judgment about how much an asset is worth by looking at what the market is paying for similar assets.

If the market is correct, on average, the values obtained by using the intrinsic valuation and the relative valuation should converge. The third approach, the contingent claims approach, values assets as options if the payoffs are a function of a value of an underlying asset. The fundamental hypotheses that sustains the use of option pricing models relies on the possibility that discounted cash flow can understate the value of assets that provide payoffs contingent on the occurrence of an event.

Value based performance assessment can represent the raw material for both intrinsic e.g. excess returns models and relative valuation approaches e.g. standardized Market Value Added. This study aims at identifying the evolution of some of the key value based indicators in the case of Romanian listed banks. In particular we compute value based measures like Residual Income RI and Market Value Added MVA but also traditional measures like Earnings per Share EPS and Price to Earnings ratio PER in order to have a detailed view on the evolution of shareholder value creation in the banking industry for last seven years 2005-2011.

2. Literature review

Investigating the performance of banking institutions represents major inters for practitioners, supervisors and scholars considering banks contributions to the optimal allocation of financial resources in the real sector. In the particular case of Romanian economy recent studies Dragotă et.al 2008, Dragotă et. al., 2011 show that bank loans represent the main external source of financing exceeding by far the role of the capital market. The banking system finances nearly all Romanian listed companies on Bucharest Stock Exchange or on RASDAQ as the short term loan represents the most preferable instrument of debt outgrowing the values of medium and long term bank credit.

The international research literature quantifies bank performance by appealing to the notion of profitability which can be captured by traditional indicators or by constructing value added indicators. Studies like Kosmidu et. al., 2007, Ben Naceur, and Omran, 2011, Olson and Zoubi, 2011 use traditional measures when explaining the evolution and determinants of financial performance. Most of the traditional banking performance measures directly relate to the current net income of a business entity with equity, total assets or use net interest margin. Common used measures are: ROA – reflecting the capacity of the bank management to transform assets into net earnings, ROE – measures the performance from the perspective of the equity holders and NIM – for measuring current and future profitability defined by the difference between a depository institution's interest income and interest expenses as a percentage of total assets. As seen each of these indices measure a different aspect of performance and thus must be considered in conjunction with each other but also with other metrics.

On the other hand, economic measurements of profit like residual income and economic value added gained increasing popularity in the field of performance assessment for financial institutions. Uyemura et. al., 1996 introduced the first comprehensive literature for EVA. Also, the study presented EVA's superiority over traditional performance measurements as it exhibits stronger correlation with bank market values than traditional accounting measures like ROA and ROE.

Fiordelisi, 2007 develops a new measure of banking performance – shareholder value efficiency – based on the maximum possible EVA given particular inputs and outputs. Using financial information from banks operating in advanced European economies in the period 1997-2002, shareholder value efficiency is found to