

Analysis of barclays bank finance essay

[Finance](#), [Banks](#)



Barclays is a British multinational bank. The headquarter of Barclays is located in One Churchill Place, London, United Kingdom. With over 300 years of history, Barclays has provides a range of financial services in 56 countries from retail banking services to customers. It offers a broad range of financial products and services including current accounts, savings accounts and general insurance. In 1986, Barclays' shares are listed on the New York stock and Tokyo stock exchanges. Moreover, in 2012, Barclays has also been ranked as one of the World's 50 Safest Banks. In order to acknowledge deeper about the Barclays, this report shall analyse important financial ratios of Barclays bank as well as application of corporate finance theories to Barclays bank during the period 5 years from 2007 to 2011.

I. BARCLAYS' PERFORMANCE

In order to analyse trends of the firm or to compare the firm's financing to those of other companies, investors usually use financial ratios which are calculated mostly based on the information from the company's financial statements. By use of ratio analysis, investors can draw the conclusion referring to some important aspects of the company, such as financial health, profitability or efficiency of the undertaking investment projects. In this report, I am going to analyse the key ratios of Barclays and make comparison with another 2 popular banks in the UK, including Royal bank of Scotland and Lloyds TSB bank.

1. Profitability ratios: " Profitability ratios are concerned with the effectiveness of the business in generating profit. A very popular means of accessing a business is to access the amount of wealth generated for the

amount of wealth invested” (Mc Laney, 2011). There are three crucial profitability ratios that I am going to examine.

Profit after tax (Net profit)

“ Net profit, also referred to as the bottom line, net income, or net earnings is a measure of the profitability of a venture after accounting for all costs. In a survey of nearly 200 senior marketing managers, 91 percent responded that they found the “ net profit” metric very useful” (Wikipedia, Net profit, 2012).

Net profit

By looking at the net profit of 3 banks in the United Kingdom, it can be noticed that Barclays has the highest profit after tax, ranging from £3, 512 million to £5126 million. Meanwhile, the 2 other banks include Lloyds TSB and Royal bank of Scotland have not only lower net profit but also going down over zero value, reaching negative profit after tax. For investors, the high net profit of Barclays can help them more optimistic when considering investment in banking sector.

b. Return on equity (ROE): “ This ratio looks at the return to the longer-term providers of funds” (Mc Laney, 2011).

This ratio measures how much the shareholders earned for their investment in the company. The rule here is that the higher the ratio, the more effective equity utilizing and the higher return for investors.

Return on equity

From the chart above, it is obvious that each £1 that shareholders invest in Barclays, they will get the higher return compared to each pound that they invest in the royal bank of Scotland. While the return on equity of Barclays has decreased slightly from 23.79% in 2007 to 9.62% in 2011, this indicator of bank of Scotland has sharply reduced to negative value during the period from 2008 to 2011. In this case, it is likely that investors are interested in investment for Barclays rather than bank of Scotland.

c. Earnings per share (EPS)

“The portion of a company’s profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company’s profitability” Investopedia ratio analysis Tutorial (<http://www.investopedia.com>)

The earnings per share of Barclays has experienced a dramatically growth in 5 years. Beginning at just 25.10p per share in 2007, this ratio has doubled to 51.40p in 2010 and reaching a peak at 68.90p in 2011. By contrast, there has been a downward trend in the earnings per share of bank of Scotland. Starting at 83.95p in 2007, significant higher than Barclays, however, the earnings per share of bank of Scotland has not maintained its high position and falling deep to -431p in the following year before looking a slightly increase in 2011 with just 2p per share. Overall, during the 5 years from 2007 to 2011, the earnings per share that shareholders can get from Barclays, has jumped 174% compared to 97% reducing in bank of Scotland’ earnings per share.

2. Liquidity ratios: In order to make investments, besides looking at the profitability of the firm, investors basically concern about its liquidity. The definition of liquidity ratio said “ Liquidity ratios are used to try to access how well the business manages its working capital” (Mc Laney, 2011).

Current ratio: “ This ratio is used as a tool to measure “ how the balance has been struck between the two aspects of working capital” (Mc Laney, 2011).

In this formula, current assets are usually cash, receivables and inventories. It is likely that current assets are important for business because the company uses them for day to day operations as well as paying ongoing expenses.

2011

2010

2009

2008

2007

Barclays

1. 03

1. 03

1. 05

1. 03

1. 03

Bank of Scotland

1. 05

1. 75

1. 04

0. 46

1. 02

Lloyds TSB

0. 56

1. 31

1. 04

1. 03

1. 04

In comparison with the standard ratio 2: 1, the current ratios of both 3 banks above are lower. This has improved that utilizing funds of Barclays, banks of Scotland and Lloyds TSB has not been efficient yet. Nevertheless, compared

to the other banks, the current ratio of Barclays is much stable over time and closer than the standard 2: 1.

II. SOURCES OF FINANCE

It seems that the problem about where to get funds to start up and develop is usually a question for the business. In reality, there are some sources to raise finance for a company, such as shareholders, bank and creditors. In this section, I am going mention about 4 kinds of finance's sources that Barclays has. That is shareholders' equity, leasing, loan and bond.

Shareholders' equity: when it comes to shareholders' equity, it is likely that it includes 2 main sources. The initial source is the money that was invested in the company at the beginning. The second source is received from retained earnings and it seems that in some cases, the retained profits portion is the largest component of shareholders' equity.

Retained profit and share capital: The retained profit is “ the portion of net income which is retained by the corporation rather than distributed to its owners as dividends”, meanwhile, share capital is “ the portion of a company's equity that has been obtained (or will be obtained) by trading stock to a shareholder for cash or an equivalent item of capital value” (Wikipedia, share capital, 2012). The biggest shareholders of Barclays until 2012 is the global investment house Qatar Holding LLC, owning 813, 964, 552 Barclays' shares, equals to 6. 67%; and the American multinational investment management organisation Blackrock Inc, with 797, 965, 930 shares of Barclays, accounting for 6. 54% ([http: www. It. hemscott. com](http://www.it.hemscott.com)).

Share capital Retained profit

Looking at the 2 charts above, it can be easily to notice that although the share capital of Barclays during 5 years is lower than royal bank of Scotland, its retained profit is significant higher than the rival. At the beginning of the given period, the retained profits of Barclays and bank of Scotland are equivalent, however, Barclays has successfully overcome bank of Scotland so far to reach £39, 372 million in 2011, leaving bank of Scotland with £18, 929 million only. This is to say that compared with the rival, Barclays might have more capital available for growth and higher returns on investments as well as shareholder equity, because the root of retained earnings is to reinvest in business.

Capital lease: One of the most important sources of long term finance nowadays is Lease financing. In lease financing, a company can rent an asset or purchase the right to spend an asset without buying it from the actual owner. There are some advantages of lease financing, such as the company might not have to face bad investments or it sometimes can also avoid big investments simultaneously.

Capital lease

2008

2009

2010

2011

Barclays

61

106

71

54

Bank of Scotland

0

0

0

0

Royal bank of Scotland during 4 years above had no capital lease that could lead to reducing its source of finance. By contrast, the higher level of Barclays in capital leasing from 2008 to 2011 has shown that Barclays might manage its cash flow more effectively than its rival, and adapt quickly to changing economic conditions, because a lease agreement just require the smaller and regular payments. Leasing also allows Barclays to upgrade assets more frequently ensuring it has the latest equipment without having to make further capital outlays.

Bonds: For the business, there are basically some ways to get sources of long term finance which is important for its operation. Besides shares, the

firm can also raise funds by issuing the other kinds of securities, such as bonds. From the investors' perspective, before decision making to purchase any bonds of particular company, they often look at its credit rating initially which assess the quality of the bonds. This credit rating is generally assessed by some credit rating agencies, such as Standard and Poor's, Moody's, Fitch and DBRS. The rating is helpful for investors as they can notice which bond is worthwhile and which one should be ignored, simply by looking at its credit rating. For example, the bond with Aaa rating is completely valuable because that rating means the highest quality and lowest credit risk. By contrast, the bond with Caa is related to the poor quality and high credit risk.

Turning back to Barclays circumstance, the table below will show its credit rating in recent years:

Standard & Poor's

Moody's

Fitch

2011: A (Stable)

2012: A3 (Negative)

2011: A (Stable)

2009: A+

2009: A1

2009: AA-

2008: AA-

2007: Aa2

2008: AA

2007: AA+

Barclays has issued bonds as a tool of increase capital. Namely, according to the information from Barclays' website, it has the 18 month flexible bond. This kind of bond of Barclays can help investors to earn 2.35% AER / gross pa 1 (Balances £1 to £49,999), or 2.55% AER / gross pa 1 (Balances £50,000 to £99,999), or earn 2.75% AER / gross pa 1 (Balances £100,000 to £1 million). The second bond is One Year Fixed Rate Savings Bond and if investors are interested in this bond, they can earn 2.00% AER / 1.98% gross pa 5 (Deposits £500 to £1 million). Besides this, Barclays has also been forecasted to sell 2 billion dollars of 5 years cover bonds in the United States of America in this year. (McGee, 2012). The 5 year covered bonds of Barclay are considered as great bonds for investors because they are a form of secured debt and having the AAA rating.

Loans: when it comes to the sources of finance of any business, loans might be considered as one of the main sources. The definition of loans said “Loans are negotiated between the borrowing business and a financial institution such as a clearing bank, an insurance business or a merchant bank. This sort of finance is extremely important, perhaps accounting for as much as 25% of new finance raised by business other than through retained profits” (McLaney, 2011). There are 2 kinds of loans, short term and long term. However, in this section, I am going to focus on the long term loans which are more stable and important for business because this is the main source of big investment projects that can make huge profits but basically require a lot of time investing.

Royal bank of Scotland had long term loans higher than Barclays 53% in 2008, meaning that its ability in mobilization debt capital is better than Barclays. However, it should also be noted that the debt capital of royal bank of Scotland has reduced nearly half after 4 years, with £117, 060 million in 2011. Meanwhile, Barclays’ debt capital begun at lower position compared to its rival but its trend was upward and finished at the higher level, with £148, 120 million in 2011. Overall, after 4 years from 2008 to 2011, the debt capital of Barclays raised more than those of royal bank of Scotland, contributing directly to the growth of the capital total.

III. GEARING AND SHAREHOLDERS WEALTH.

Gearing: Simply speaking, gearing is considered as a tool to measure the risk of the company. It refers to comparing some form of owner’s equity (or capital) to borrowed funds. If a company has the higher gearing ratio than its rival, it means that it is more risky. The issue here is how this ratio affects the value of company. The answer might be founded in the Modigliani and Miler theory in 1958 and 1963.

Modigliani and Miler theory

The proposition 1: In 1958, Modigliani and Miler, 2 professors of Carnegie Mellon University, published the theory about capital structure. The content of the theory is that the firm’ value is not affected by its capital structure in a perfect market,. Therefore, the total value of the firm is stable in spite of debt to equity ratio. To support this assumption, let’s imagine that two companies with the same operation of business but different in the capital structure. Where firm A is unlevered, the total value of its equity (EU) is the

same as the total value of the firm (VA) . Additionally, where the firm B is levered, thus the total value of the firm B is equal to the value of the debt less value of the equity of the firm B. As a result, the total value for both companies will be the same. Because both Modigliani and Miler (1958) believed that when there are no taxes and capital markets function well, it makes no different whether the company should borrow or individual shareholders should borrow. The market value of a company does not depend on its capital structure. They demonstrated the assumption by represent that the arbitrage opportunity would emerge if the total value of the company related to capital structure. The arbitrage should not be in the practical and real situation. The proposition 1 can be illustrated as $V_B = V_A$. In other words, it is the value of the levered company equals to the value of the unlevered company. In order to demonstrate that their proposition 1 was feasible, they made the assumption that there are no tax and transaction cost exist in the market. Individual and corporation can borrow at the same rate. However, there are then a large number of articles debated with their article because it seems to be unrealistic. As a result, the proposition 2 has come.

The proposition 2: In 1963, 5 years after the first proposition came, Modigliani and Miller published the proposition 2 to modify proposition 1 by considering the corporation tax. It said that the expected rate of return on the common stock of a levered company increases in proportion to the debt-equity ratio. The proposition 2 says that when the debt to equity ratio raises then the expected rate of return will increase as well, leading to the increase of risk. As a result, shareholders expect the high rate of return according to the level

of risk they face. Therefore, the company might take benefit as levered company rather than maintaining the status as unlevered company because the corporation can deduct interest payment as an expense but dividend payment are non-deductible. As Modigliani and Miller theory stated that the optimal capital structure will exist where the weigh average cost of capital (WACC) minimize and the total market value of the company maximize. The theory of Modigliani and Miller with tax illustrated that gearing up by raising debt finance rather than equity finance reduces the WACC and the value of the firm increase. Ultimately, an optimal capital structure does exist at point where debt is 100%. The formula of the proposition 2 is: Value of levered company = Value of unlevered company + Value of tax saving. This formula is used to give assumptions that there is corporation tax in the market but without transaction cost exists. The individual and corporation can still borrow money at the same rate. Hence, the best of capital structure should be 100% debt finance because of tax deductible on interest.

Overall, firstly Modigliani and Miller theory in 1958 ignored taxation, but following that, in 1963, they modified the model by implication corporation tax. From here, it is suggested that the higher the level of taxation, the lower the combined cost of capital, meaning that if the company use higher level of the gearing, the higher the value of the company. The firm financial strategy should choose a 99.9% gearing level. Nevertheless, in practice, most of the company cannot go for high levels of gearing because according to Modigliani and Miller theory is still far from perfect. They distort the problems which can occur from raising high level of gearing such as bankruptcy risk. There is the possibility of bankruptcy as gearing increase

result in increase the WACC and the value of the share price reduce. Moreover, the agency cost is also the main problem does not exist in Modigliani and Miller theory.

Applying the theory to Barclays, initially let's look at its gearing. Here is the gearing ratio for both Barclays and royal bank of Scotland:

2011

2010

2009

2008

2007

Barclays

53. 09

n. s

54. 61

912. 12

n. s

Lloyds TSB

782. 35

543. 90

129. 01

212. 56

121. 80

It can be noticed from the table above that if the gearing of Lloyds TSB bank has increased from 121. 80% in 2007 to 782. 35% in 2011, this ratio for Barclays is completely opposite, with reducing gearing from 912. 12 in 2008 to just 53. 09 after 3 years. In other words, Barclays has used little debt in its capital structure. This is to say that it will has less financial risk than royal bank of Scotland.

IV. DIVIDEND POLICY.

The issue of how dividend policy affects a firm's value has been debated widely. Firstly, the tax clientele effect. In 1970, Elton and Gruber stated that high income shareholders are related to low dividend shares, meanwhile low income shareholders are associated with high dividend shares. Furthermore, investors often have different requests and purchases shares whose pay out suit their needs. Therefore, it is crucial for companies to change the dividend policy. Secondly, the information signalling. Pettit in 1972, Aharony and Swary in 1980, Asquity and Mullins in 1983, said that the share prices of the company reacts to unexpected changes in dividend policy. Lintner's interviews with the corporate managers from the 1950s on payout policies highlighted 4 key ideas. Namely, companies have a long run target dividend payout ratio. Then managers focus on more dividend change than the

absolute levels. Following that, dividend changes only follow shifts in long run sustainable earnings. Next, management are reluctant to make changes that might have to be reserved, especially rescinding an increased dividend. In 1988, Healey and Palepu notices that on average earnings raising 43% in the year a dividend as paid for the initial time, and earnings kept going to rise in the following years. In 1987, Ofer and Sieger stated that when a dividend increase is announced, analysts up their forecasts of current year earnings. Generally, investors are not interested in the level of dividend because they are nervous about change. Dividend change is an important indicator of sustainability of earnings. There are still 3 debates around the payout. Let's mention about the radical left payout policy first. The radical left said that when the dividend rises, then the value of the company will be decreased. Where dividends are taxed more than capital increases, the company should pay the lowest cash dividend possible. Existing cash should be retained or spent to repurchase shares. The businesses may transmute dividends into capital gains. If this decreases taxes, it then should be welcomed by any tax paying investors. If dividends are taxed higher than capital gains, investors basically should pay more for shares with low dividend yields. Leftist position calls for zero payouts whenever capital gains have a tax benefit. In November 2007, darling signalled a capital gains tax concession with near immediate effect to 18%. In 1982, Litzen Berger and Ramasway summarise that investors price shares as if dividend income attracted an extra 14-23% tax rate. Currently, top tax rate in the united states of America is 15% for dividends and capital gains. Focusing on the united kingdom, dividends are taxed at income tax rate.

Capital gains firstly at £9000 tax free, then income tax rate applies. The second payout policy is the rightists. This policy stated that if increasing dividend, then increasing value of the company. In 1951, Graham and Dodd said that some financial corporations are legally restricted from holding shares lacking established dividend records. Moreover, trusts may prefer high dividends because dividends are considered as spendable income for them whereas capital gains are additions to principal. Following that, the clientele look for the steady source of cash from their portfolio to live off. The regular dividends relieve many shareholders of high transaction costs and inconvenience. The regular dividends relieve shareholders of risk of selling shares at temporarily depressed prices. In 1963, the theory bird in hand fallacy is published with traditional view that at any time, £1 in dividend is more worthwhile than £1 in retained cash flow, even if the cash flow might have been invested in positive net present value projects. In 2000, the theory of Allen said that well managed firms want to signal their worth. They may do this by having a great proportion of demanding institutions among their investors by paying high dividends. Moreover, shareholders do not object to these high dividends as long as the effect is to encourage institution investors who are prepared to put time and effort into monitoring management.

Finally, the centre policy shows that the payout policy makes no difference. Coming back to Modigliani and Miler in 1961, they stated that dividend pattern is not relevant and should be treated as a residual after investment decisions have been made. They also published an article showing irrelevant of dividend policy in a no tax or no transaction cost. Investors can effectively

create homemade dividends if required. The value of a firm is determined by its assets and cash flows generated. Shareholders wealth is enhanced only by the investment decision. Furthermore, the retained earnings and safe borrowing finance positive net present value projects. Any surplus is paid out as a dividend. Thus, if the firm wants to raise its dividend, it has to issue new equity to fund it. Therefore, reducing the share prices as value is transferred from old to new shares and this share price decline is offset by the increased dividend, then the dividend policy cannot change the value of the company. In the centre dividend policy, besides the theory of Modigliani and Miler in 1961, there are another view from Black, Miler and Scholes in 1974. Their theory stated that the value of the company is not influenced by its dividend policy. The supply of dividend is also free to adjust to demand. The researchers above gave the view that no company believes dividend could add value by changing the dividend payout. This supply debate is not consistent with the clientele effect of investors who prefer low dividend shares. Some investors might prefer high payouts and they have a wide choice.

For Barclays, its dividend policy is to pay cash dividends on a quarterly basis. There will be three equal quarterly payments in June, September and December and a final variable payment in March each year.

Barclays

2011

2010

2009

2008

2007

Dividend Cover

4. 18

5. 53

9. 64

4. 47

2. 03

Dividend Yield

3. 40%

2. 10%

0. 90%

7. 50%

6. 90%

Dividend per share

6

5.5

2.5

11.5

34

Although the dividend per share and dividend yield of Barclays has reduced from 2007 to 2011 from 34p to 6p and 6.90% to 3.40% respectively, its dividend cover has seen a significant signal when dividend cover ratio of all 5 years above is higher than the standard ratio 2:1, meaning that Barclays can well afford the dividend.

Section 5: Mergers, acquisition and corporate restructuring

The theory of merger said that “ where the two business are of similar size or there is agreement between the two sets of managements as to the desirability of the outcome, then it tends to be referred to as a “ merger” (McLaney, 2011). There are some reasons for acquisition and merger of the business. The first reason of consolidation is related to the capacity. Acquiring another business might help it increase capacity quickly. However, the problem here is that in some cases, although the cost of acquisition is significant, probably trillion pounds, the firm still accept acquisition. The reason is relevant to the economies of scale. Simply speaking, If a company doubles its costs as a result of investing in an acquisition but its output rises by 130%, then its average costs or it is called the costs per unit will decrease. Firms gaining economies of scale from an acquisition will expect to use the benefits it gains from lower unit costs to either boost its profit

margins or enable it to be able to compete with its rivals more effectively. The final reason for consolidation is technology. Take for example the outstanding acquisition recently between Facebook and Instagram – one of the popular social networks where users can share their photos free. According to Zuckerberg – chairman of Facebook, the aim of this acquisition is that Facebook wants provide for customers the best photo sharing experience that Instagram is having. He posted on his own blog: “ This is an important milestone for Facebook because it’s the first time we’ve ever acquired a product and company with so many users. We don’t plan on doing many more of these, if any at all. But providing the best photo sharing experience is one reason why so many people love Facebook and we knew it would be worth bringing these two companies together” (Malik, 2012).

Coming back to Barclays, its acquisition and consolidation with the other has helped Barclays not only expanding its branch network around the world but also diversifying business sectors. For example, in 1918, Barclays consolidated with the London, Provincial and South Western Bank, becoming the United Kingdom’s ‘ big five’ banks. By 1926, Barclays had 1, 837 branches. In 1986, Barclays global expansion was given added impetus with the creation of an investment banking operation, known as Barclays Capital. In 1995, Barclays purchased the fund manager Wells Fargo Nikko Investment Advisers. The business was integrated with BZW Investment Management to form Barclays Global Investors. In 2008, Barclays Capital acquired Lehman Brothers’ North American investment banking and capital markets businesses. This acquisition cemented Barclays Capital position for its clients with a leading presence in all major market including equities, credit, fixed

income, mergers and acquisitions, commodities trading and foreign exchange.

Section 6: The efficient market:

The efficient market hypothesis has been debated in finance sector because of its important implication. In 1970, Eugene Fama at the University of Chicago defined a market as being efficient if prices fully reflect all available information. According to Fama, the efficient market hypothesis can be classified into three groups: weak form, semi-strong form, and the strong form. Firstly, I am going to focus on the weak form of the efficient market hypothesis which said that when current prices fully reflect all information contained in past prices, then the market is being determined efficient. The weak form of the efficient market means that past prices may not be used as a predictive tool for the future movements of shares price. Thus, it is impossible for a trader to make abnormal returns by using only the past history of prices. In other words, a market is efficient in the weak form if stock prices follow a random walk process. According to Fama (1970), market efficiency under the random walk model implies that successive price changes of a stock are independently and identically distributed, so the past movement or trend of a stock price or market cannot be used to predict its future movement. Practically, several statistical techniques, such as runs test, unit root test, serial correlation tests, and spectral analysis, have been commonly used for testing weak form efficiency. The most highly regarded of serial correlation tests was conducted by Fama(1965). Similarly, Brealey (1970) and Cunningham (1973) conducted the same tests on security prices

in the London Stock Exchange , one of the world's leading stock market, and noticed evidence of weak form efficiency.

Secondly, the semi-strong form. The semi-strong form of the efficient market hypothesis indicates that current market prices reflect all publicly available information, such as information on money supply, exchange rate, interest rates, announcement of dividends, annual earnings, stock splits, etc. This means that it is impossible for market participants to make consistently superior returns just by analysing annual reports or other published information because market prices will be immediately adjusted to any good or bad news contained in such reports as they are revealed. Empirical studies of semi-strong had been made possible by the new capital asset pricing model of Sharpe (1964) and Lintner (1965). This allowed researchers to disaggregate individual security's returns into a component due to broad market moves and a " residual" component specific to each security. Semi-strong efficiency was tested by assessing the behavior of those residuals leading up to and following announcements. Fama, Fisher, Jensen and Roll (1969) performed such a study around announced stock splits. Ball and Brown (1968) did so with quarterly earnings announcements. Scholes (1969) considered new stock issuances as well as large underwritten sales of existing common stock. All these studies gave strong support for semi-strong market efficiency.

Thirdly, if a market is strong form efficient, then market prices of securities reflect all relevant information, including both public and private information. The strong form of efficient market hypothesis implies that private

information (inside information) is hard to obtain for making abnormal returns, because if a market participant wants to have it, he/she has to compete with many active investors in the market. It is crucial to note that an assumption for the strong form is that inside information cost is always zero. However, this assumption hardly exists in reality, so the strong form of efficient market hypothesis is not very likely to hold.

As mentioned above, London stock exchange is efficient,