



Investment Decisions: Bank Valuation

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Equity Value – Value for Owners

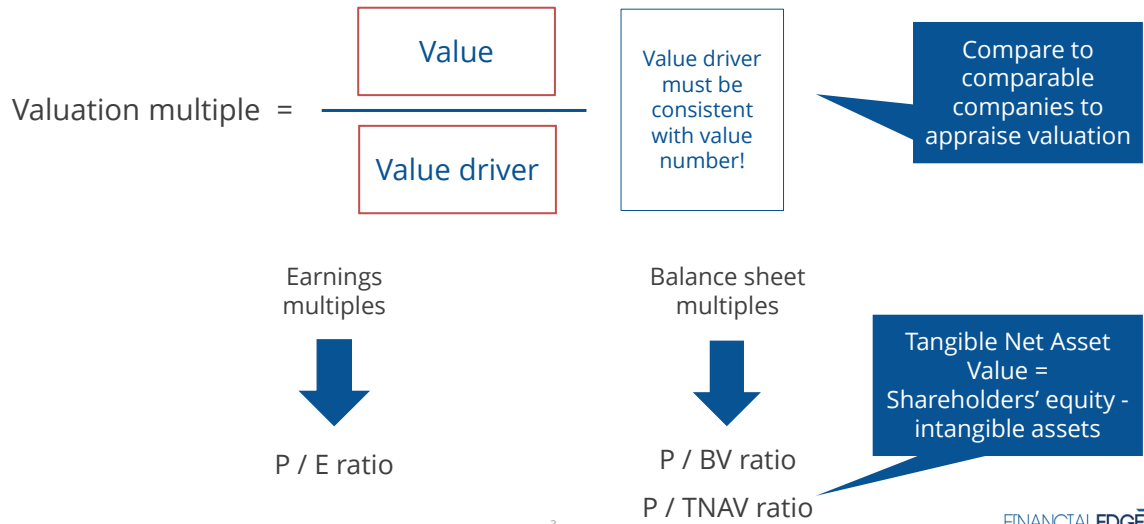
Also known as market value or market capitalization (traded company)



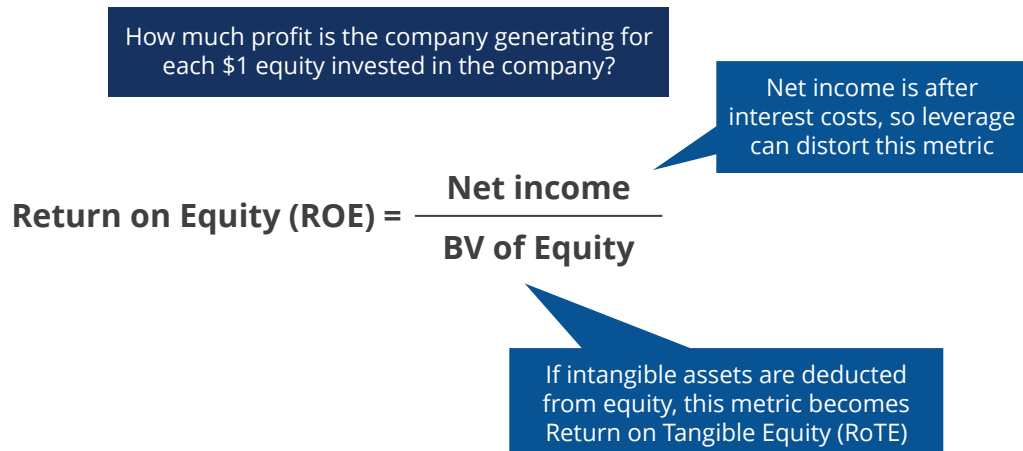
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Valuation Multiples in Banking



Return on Equity



Growth, Risk and Returns

The Gordon Growth Model for a growth perpetuity explains the link between growth, risk and returns

$$\text{Equity value} = \frac{\text{Dividends}_{n+1}}{\text{Cost of equity} - g}$$

If dividends increase, the value of equity increases

If risk (therefore cost of equity) increases, the value of the company decreases

If g increases, the value of equity increases

What about returns?
First we need to understand the link between dividends and returns...

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Dividends and Returns

The financials for a company in 20X1 show the following:

	20X1
Opening shareholders' equity	
Net income	200
Dividends	
Closing shareholders' equity	

The company's return on equity is 20.0%

The growth rate of equity is \$60/\$1,000 = 6.0%

So dividends = net income - g * opening equity...

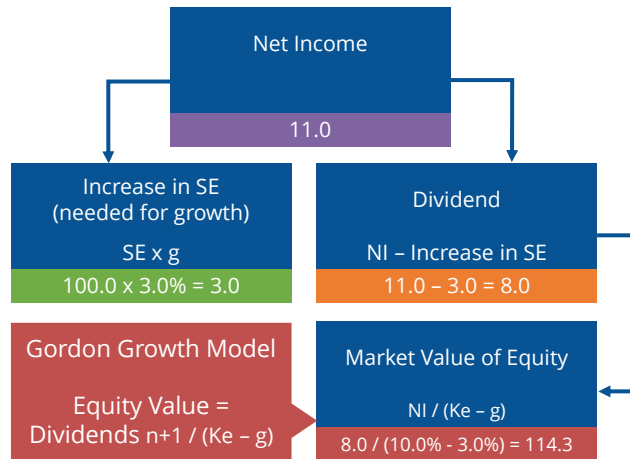
$$\text{Equity value} = \frac{\text{Net income} \times (1 - \frac{g}{ROE})}{\text{Cost of equity} - g}$$

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Impact on Multiples

Beginning Shareholder's Equity	100.0
Growth in Shareholder's Equity	3.0%
Return on Equity	11.0%
Cost of Equity	10.0%

B	Beginning Shareholder's Equity	100.0
A	Add Net Income	11.0
S	Subtract Dividends	8.0
E	Ending Shareholder's Equity	103.0

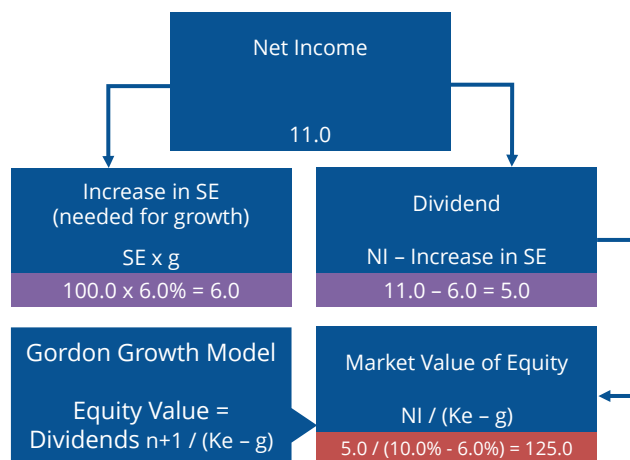


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Impact on Multiples

Beginning Shareholder's Equity	100.0
Growth in Shareholder's Equity	6.0%
Return on Equity	11.0%
Cost of Equity	10.0%

B	Beginning Shareholder's Equity	100.0
A	Add Net Income	11.0
S	Subtract Dividends	5.0
E	Ending Shareholder's Equity	106.0



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Impact on Multiples

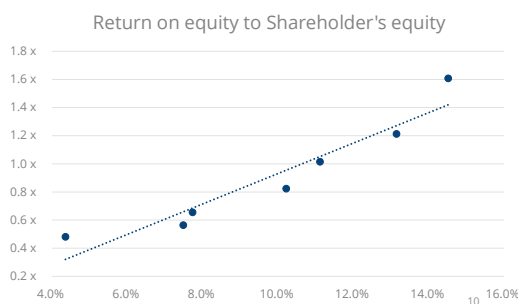
	Base	High ROE	High g	Low cost of equity	ROE = cost of equity
Shareholders' equity	100.0	100.0	100.0	100.0	100.0
ROE	11.0%	15.0%	11.0%	10.0%	10.0%
Cost of equity	10.0%	10.0%	10.0%	8.0%	10.0%
Growth	3.0%	3.0%	6.0%	6.0%	6.0%
Equity value	114.3	171.4	125.0	200.0	100.0
Net income	11.0	15.0	11.0	10.0	10.0
P/E Multiple	10.4 x	11.4 x	11.4 x	20.0 x	10.0 x
P/BV Multiple	1.1 x	1.7 x	1.3 x	2.0 x	1.0 x



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Banking Performance

Bank	Market Cap	Shareholder's equity	Return on equity	P/BV
Wells Fargo	242,176.5	150,579.0	14.5%	1.6 x
JP Morgan	233,916.5	192,625.0	13.1%	1.2 x
Lloyds Bank	37,978.1	37,380.0	11.1%	1.0 x
BAML	148,041.4	179,589.0	10.2%	0.8 x
Citigroup	127,285.6	194,006.0	7.7%	0.7 x
Barclays	26,139.0	46,283.0	7.5%	0.6 x
RBS	22,617.6	46,894.0	4.4%	0.5 x



Average RoE 9.8%

Return on equity drives value

How can banks increase RoE?

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