How to Value Banks? A Different Valuation Framework

Valuing banks requires a fundamentally different approach compared to valuing non-financial companies.Through my learning journey, I realized that many traditional corporate valuation tools—such as Enterprise Value, WACC-based DCFs, and reinvestment-driven growth models—do not apply cleanly to banks due to their balance-sheet-driven nature.

The core difference lies in **how banks generate earnings and deploy capital**.

For non-financial companies:

- Debt is a **source of financing**
- Interest expense is **non-operating**
- Assets like PP&E drive cash flows
- Growth depends on reinvested cash flows

For banks:

- **Debt (deposits) is raw material**, not financing
- Interest expense is a **core operating cost**
- **Loans are operating assets**
- Growth depends on **regulatory capital**, not free cash flow

Why Enterprise Value and Traditional DCF Do Not Work for Banks

Enterprise Value assumes a clear separation between:

- Operating assets
- Financing structure

In banks, this separation does not exist:

- Deposits are both funding and operating liabilities
- Interest income and expense are operating line items

Additionally, bank growth is constrained by **capital adequacy requirements**, not by how much cash the bank chooses to reinvest. Since traditional DCF relies on reinvestment and WACC, it becomes unsuitable for valuing banks.

Intrinsic Valuation of Banks: Dividend Discount Model (DDM)

Banks are naturally suited for the **Dividend Discount Model**, because:

- They pay regular dividends
- Dividends are tightly linked to profitability and capital adequacy

Structure of a DDM Valuation

Discrete Forecast Period First we have to Project the net income and dividends, Ensure dividends comply with regulatory capital constraints and Discount these dividends using **Cost of Equity (not WACC)**

Terminal Value : The Terminal Value is Estimated using Perpetuity growth method, or Exit multiple method (P/B or P/E).

<u>Important things I learnt with respect to payment of Dividends:</u>

Dividend payments for banks are constrained to **Targeted CET1 ratio (Common equity Tier 1 capital)**

Growth (Perpetual Growth Rate) is limited by **retained earnings and ROE**

RESIDUAL INCOME APPROACH FOR VALUATION

Under this approach, the residual income is projected and then discounted back to the present.

Residual income = Net income - Cost of Equity

Extra income generated by the company over and above the minimum return given to the shareholders (Ce)

Cost of equity = Beginning equity * Cost of Equity

Residual Income = (ROE − Cost of Equity) × Beginning Equity

I have used this approach when the dividends are constrained.

ONE PAGE SUMMARY

Why Banks Are Different Banks treat debt (deposits) as operating raw material rather than financing. Interest income and interest expense are core operating items, and growth is constrained by regulatory capital rather than discretionary reinvestment decisions. As a result, traditional enterprise valuation frameworks lose relevance.

Why Enterprise Value and Traditional DCF Do Not Work - In banks, operating and financing activities are inseparable. Deposits fund loans, and leverage is integral to business operations. Growth depends on regulatory capital adequacy, making WACC-based free cash flow models unsuitable.

Intrinsic Valuation: Dividend Discount Model (DDM) - Banks are well-suited for DDM as dividends are regulated, recurring, and directly linked to profitability and capital adequacy. Valuation focuses on projected dividends discounted at the cost of equity.

Role of Regulatory Capital

Dividend payouts and growth are constrained by CET1 and capital adequacy requirements. Retained earnings fuel growth, making capital sustainability central to valuation.

Terminal Value Approaches - Terminal value can be estimated using perpetuity growth based on ROE and retention ratio or justified valuation multiples such as P/B derived from fundamentals.

Residual Income Model - Residual income valuation focuses on excess returns over cost of equity. Firm value equals book value plus the present value of future residual income.

Relative Valuation - Banks are commonly valued using Price-to-Tangible Book Value, which reflects profitability of loss-absorbing capital and improves peer comparability.

Final Takeaway - Banks are balance-sheet-driven institutions. Their valuation must focus on equity returns, regulatory capital, and sustainable profitability rather than enterprise value or free cash flows.
