Art'o'val Advisors

True Art of Valuation

Banks Primer Summary

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Bank’s Business Model – Bird Eye View

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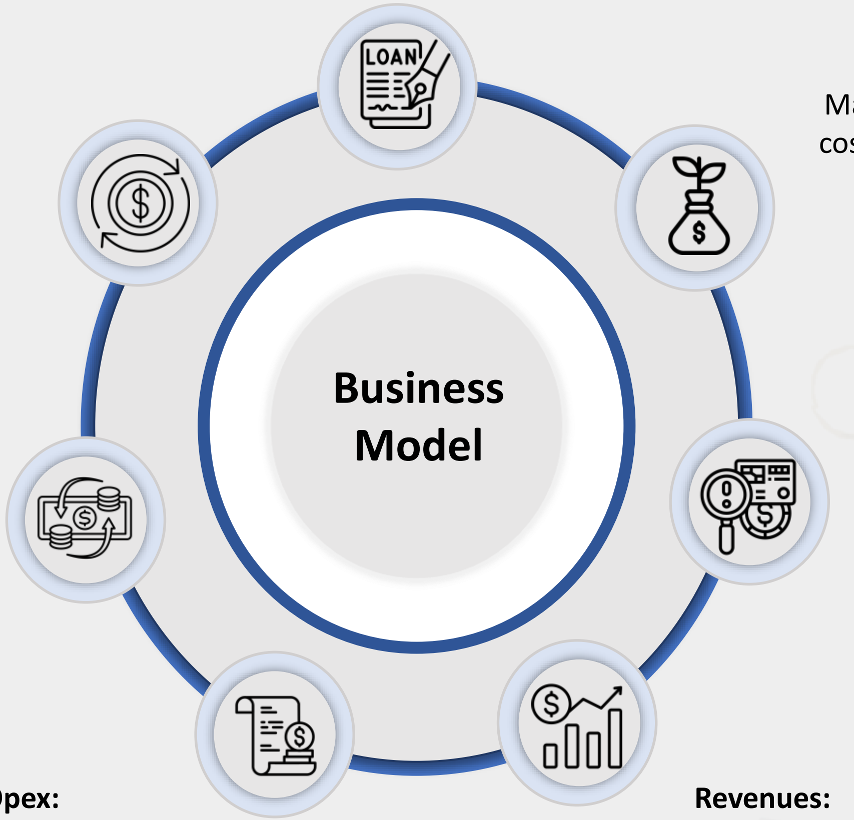
Grow Loans:
At as high risk adjusted yields, subject to regulatory capital and funding capacity



Source Funds:
Manage funding profile at lowest cost possible and high stability for strong liquidity

Manage Credit Risk:
Across credit cycles in order to minimize costs

Revenues:
Earn a strong NIM and focus on growth of interest and non interest revenues

Opex:
Manage operational costs to achieve operating leverage, while investing in digital capabilities.

ROA:
Combine all factors above to earn a relatively high ROA

ROE:
Maximize ROE while keeping regulatory buffers optimal

Understanding Bank's Balance Sheet

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Working Capital	Banks function by providing credit to businesses and individuals, using deposits and other funding sources. These funds form their working capital, a key part of the balance sheet.
True Representation of Assets & Liabilities	Bank assets and liabilities are typically close to their fair value, unlike non-financial firms where valuation is based more on earnings and intangibles like brand reputation.
Drivers of Revenues & Earnings	Profitability is driven by interest income from loans and investments, along with funding sources and deposit levels. Interest rates and operational costs also impact profits.
Equity & Valuation	The "Net Asset Value" (NAV) or "Book Value" represents a bank's equity traded in the market. Accurate calculation of NAV, excluding non-usable items, is crucial for fair market valuation.
Risk Consideration	Understanding the risks a bank assumes is critical to fully grasping the balance sheet and its valuation. Standardizing metrics like book value and ROE allows for comparability across banks.

Key Risk Categories for Banks

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Credit Risk	• The most critical risk, stemming from loans and investments. Asset quality directly impacts long-term bank performance.
Liquidity Risk	• Ensuring sufficient liquid assets to cover obligations. Measured by the Liquidity Coverage Ratio (LCR).
Interest Rate Risk	• Changes in interest rates affect interest margins and asset/liability values, influencing overall profitability.
Equity Market Risk	• Fluctuations in market value of equity investments.
Operational Risk	• Includes digital, reputational, and operational risks, with increasing focus on issues like data breaches and regulatory compliance.

The Importance of Credit Risk

- **Asset Quality vs. Earnings Cycle**:
- Asset quality is the most crucial factor in determining long-term success. A bad loan cycle can drastically reduce a bank's market valuation.

- **Case Study: Indian Banks (2015-16):**
- PSU banks revealed much higher NPA ratios due to political interference, leading to lower market valuation compared to private banks despite similar recent performance.

Other Key Risks & Funding Profile

Operational Risks

- Beyond credit, risks like digital failures, regulatory penalties, and data breaches are increasingly important. These can significantly impact stock prices and reputation.

Funding Profile

- A stable funding source is crucial for managing liquidity risk and interest costs. The funding profile is essential for both the stability and profitability of the bank.

Loan Types & Risk

Retail & Card Loans: High yield, moderate risk, unsecured.

SME & Wholesale Loans: High risk, cyclical, varied security.

Mortgage Loans: Low yield, low risk, secured.

Microfinance Loans: Highest risk and yield, specific to emerging markets.

Valuation Fundamentals

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Valuation Methods

Absolute vs. Relative Valuation	• Absolute valuation (e.g., DDM) is challenging but possible; relative valuation is generally preferred. Relative valuation compares a bank's risk, growth, and returns against sector peers.
P/BV and P/E Metrics	• Financial firms are uniquely valued through Price-to-Book Value (P/BV) and Price-to-Earnings (P/E) ratios.

Determinants of Bank Valuation

Return on Equity	• A vital profitability metric, influenced by the entire income statement.
Growth	• Focus on loan growth for short-to-medium terms (quarterly to 5 years), which is often assumed to translate into long-term growth.
Cost of Equity	• Reflects market factors, loan book risk (e.g., NPAs), and loan mix (e.g., unsecured loans carry higher CoE).

Earning vs. Market Valuation

Market Expectations: A strong bank doesn't guarantee strong stock performance if the market expectations aren't met.

Balance Sheet and Stock Value: Even well-capitalized banks can see limited stock growth if returns merely cover CoE without exceeding it.

Revenue Components & Key Earnings Metrics

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Net Interest Income (NII)

- Reflects difference between loan yields and cost of funds. Sensitive to government interest rate policies, economic cycles, and competition for deposits.
- **Loan Growth:** Crucial for expanding NII. Different segments like credit cards or mortgages affect yields and risk levels differently.

Non-Interest Income

- Includes fees from loans, corporate financing, and commissions (e.g., insurance, asset management).
- Key focus on recurring non-interest income for revenue stability. High-margin sources, like third-party commissions, offer competitive advantage.

Operational Metrics

- **Cost-to-Income Ratio**: Measures operating efficiency.
- **Pre-Provision Operating Profit (PPoP):** Core earnings before loan-loss provisions, reflecting the bank's capacity to manage potential loan losses.

Core Financial Performance Indicators

Cost-Income (OpEx) Ratio: Reflects operating efficiency; improvement is crucial for management.

Loan Loss Provisions (LLP): Provisions for expected credit losses; influenced by Non-Performing Assets (NPAs) and economic cycles.

Pre-Provision Operating Profit (PPoP): Indicates core operating earnings before loan-loss provisions, vital for absorbing potential losses.

Return on Assets (ROA): Measures profitability relative to total assets.
Return on Equity (ROE): Indicates profitability relative to shareholders' equity.

Regulatory Capital Framework

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- **Basel III and Basel IV:** Regulatory frameworks ensuring adequate capital to manage risks and ensure financial stability.

- **Minimum Capital Requirements:**
  - **CET1:** 4.5% of risk-weighted assets (RWA).
  - **Total Capital:** 8% of RWA, including CET1 and additional capital.

- **Capital Buffers:**
  - **Conservation Buffer:** Additional 2.5% of CET1.
  - **Countercyclical Buffer:** Up to 2.5% of CET1, applied during high credit growth.

- **Components of RWA:** Includes Credit Risk, Market Risk, Operational Risk, and Off-Balance-Sheet Exposures.

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Thank You

neerav.gala@artovaladvisors.com