METRICS TO EVALUATE COMPANIES IN FINANCIAL SERVICE SECTOR

The financial services sector includes a variety of companies that provide financial services to retail and commercial consumers. The three primary industries within this sector are banks, investment firms, and insurance companies.

Investment banks are key in driving the overall financial markets since they provide the capital that enables new corporations to begin operations and existing corporations to expand.

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Several financial service firms have operations globally, as well as an ever-growing presence in emerging market countries.

Insurance companies are an integral part of any society as they protect people against unexpected losses in a variety of areas. Investment firms, such as mutual funds and hedge funds, provide an opportunity for individuals to put their money to good use and grow their wealth.

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Though the fundamentals of evaluation apply to nearly every type of firm, some critical and unique aspects of the financial services sector affect how it is valued.

Companies within this sector operate under much stricter government regulations than the average corporation. Also, a key variable in the evaluation of a company's soundness is debt, but a financial service firm's debt is not always easily measured or defined.

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Thus, the firm value and the cost of capital are difficult to estimate.

Many different financial ratios can help evaluate a company in the financial services sector, two of the best metrics are the price-to-book (P/B) ratio and the price-to-earnings (P/E) ratio.

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Price-To-Book (P/B) Ratio

The P/B ratio, also referred to as the price-to-equity ratio, is utilized by traders and investors to compare the book value of a stock to its market value.

Low P/B ratios can be an indication of stock undervaluation. This metric is suited to the evaluation of the financial services sector specifically because historical analysis has shown that the ratio can accurately track the intrinsic value of financial service firms.

Price-To-Earnings (P/E) Ratio

The P/E ratio shows the relation of a company's stock price to its earnings and is also a favoured metric for evaluating financial service firms.

A high P/E ratio is interpreted as signalling increasingly higher earnings for investors. This ratio is useful in the evaluation of the financial services sector because it indicates the likely future growth of a company.

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Other Ratios to Use and Not to Use

Discounted cash flow, although favoured by some analysts, is a metric that is not considered particularly appropriate for evaluating companies in the financial services sector. This is because the nature of financial sector businesses often makes it difficult to specifically identify what constitutes capital expenditures and to accurately measure cash flow.

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More preferred evaluation metrics beyond the P/B ratio and the P/E ratio include return on equity (ROE) and the price-to-earnings-to-growth (PEG) ratio.

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