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Alphabet Soup – the DCF

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We talked recently about the PE or Price Earnings ratio as a measure of the value of a share. It compares the share price to a company's earnings, and the resulting ratio can then be compared with similar companies or with the company's historical PE.

There are other valuation methods that can be used, and one of the favourites for share market analysts is the Discounted Cash Flow valuation. The DCF is generally regarded as the most academically pure valuation because it focuses on cash flow generated by a company, rather than earnings which, as I have mentioned in previous columns, can sometimes be misleading.

Valuing a company is subjective because you have to make many assumptions about the future. During highly volatile periods such as the credit crisis of 2008/9, valuation becomes even more challenging.

How can we determine a company's PE when the "E" becomes entirely uncertain? And how do we know whether a PE level that was considered reasonable pre-crisis, will still be appropriate post-crisis?

A DCF valuation goes some way to coping with these uncertainties because it focuses on the cash flow that a company will generate from operations, which is, theoretically, easier to forecast than earnings.

Also, a DCF valuation attempts to put a value on a company that is absolute rather than relative. That is, a DCF valuation enables an analyst to say 'this company's shares are worth \$3.75' whereas a PE multiple highlights that a company's shares 'might be expensive at \$3.75, relative to its peers and to its historical PE'.

The calculation for a Discounted Cash Flow valuation is quite complex and somewhat off-putting for people like me who don't enjoy maths! To complete a DCF valuation you need to project a company's future cash flows (for up to ten years) and then discount them back to the present. The logic is that the value of a financial asset today is the value of the total future cash flows that it will generate.

Obviously the inputs that you use in your DCF calculation will determine the output. The lower the cash flow estimates you use, the lower the valuation. In order to discount the cash flows back into today's dollars, you need to determine an appropriate discount rate or interest rate. The higher the discount rate you use, the lower the valuation.

You also need to decide what rate of growth the company might achieve beyond the ten years you are forecasting. This is where things can get really subjective – it is hard enough to forecast a company's fortunes one year out, let alone in ten year's time!

I think that while it is important to get a sense of how expensive a company's shares are, valuations are only part of the total equation, and should not be relied on. Valuations can provide reassurance that you are not paying too much, but the important aspects of determining a company's long-term value are the subjective ones – what is the company's competitive advantage, how good is the management, and how has it performed historically?

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