BASIC PRINCIPLES OF FINANCIAL VALUATION DISCOUNTING

Discounted Cash Flow as the Basis for All Valuation

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DISCOUNTED CASH FLOWS (DCF)

- Method of valuing an investment
- Uses all anticipated future cash flows
- Discounts all cash flows back to present value

VALUATION BY DCF

Why do investors buy different assets?

- Real Estate
- Stocks
- Bonds

Because they want to earn a return and use the money later.

Cash is King!

WHAT GIVES AN INVESTMENT VALUE?

How much cash is coming in?

When is the cash coming in?

With these two answers we can put a value on anything!!!

BOND

- Contract between an issuer and a bondholder
- Buyer of bond lends money (principal) to issuer
- Issuer pays interest on loan and repays principal at maturity

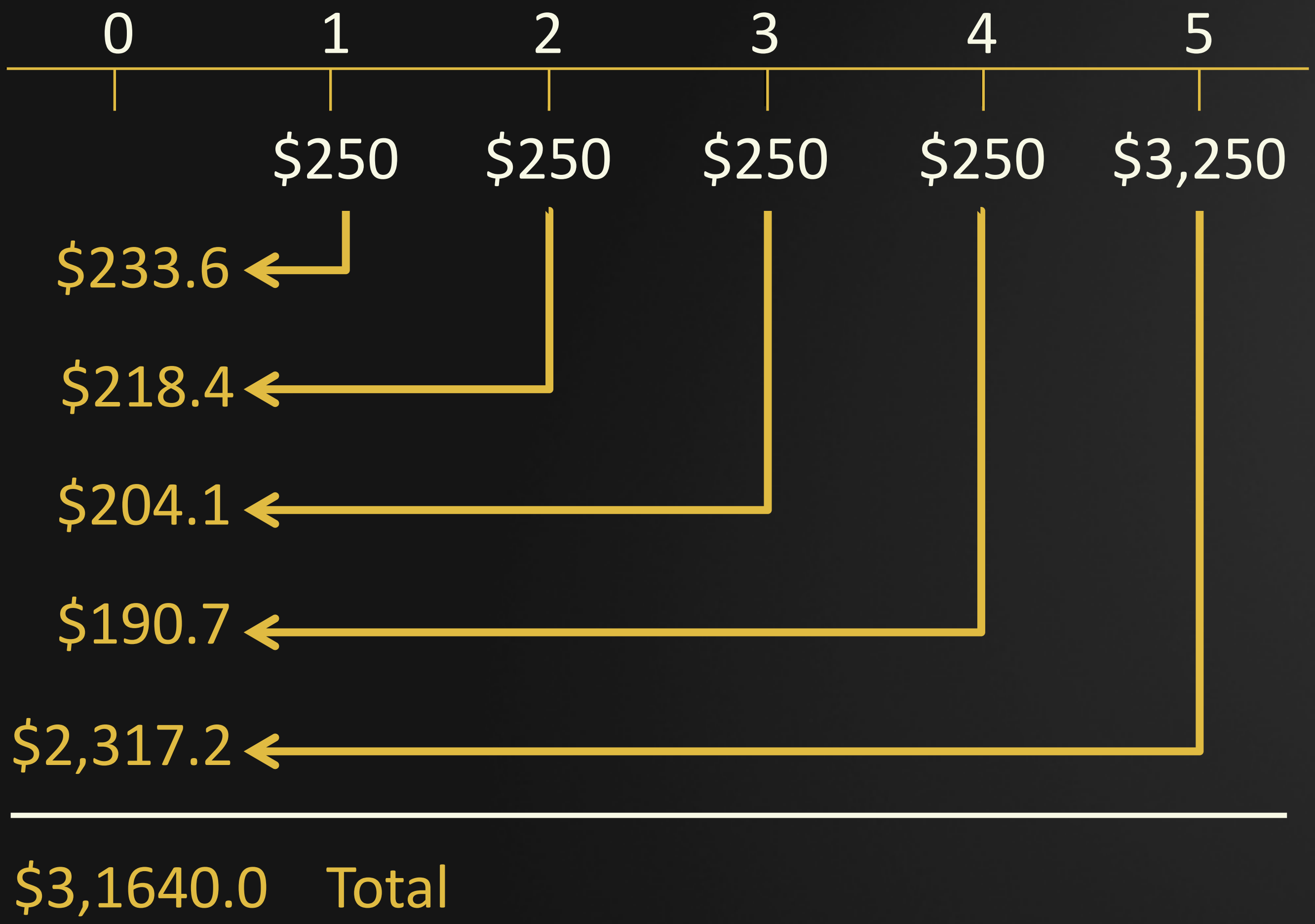
DCF: SIMPLE BOND

Consider a simple bond of $3,000 that makes annual payments of $250 for 5 years if the discount rate is 7%?

What is it worth?

- Step 1: What are the cash flows
- Step 2: What are they worth today?
- Step 3: Add up the present values

DCF: SIMPLE BOND



DCF: SIMPLE BOND

In our example the bond is worth $3,164. That is how much money the bond would raise if sold today.

Why would anyone pay more or less?

DCF: STOCK VALUATION

Share of General Electric

Cash to Shareholders? When?

Model both of these and DCF!

This is (partly) what stock analysts do

DCF: OTHER ASSETS

Apply the principle to any asset:

- Real Estate
- Mergers and Acquisitions
- Derivatives

Cash and timing drive all valuation