Module 4

The Language and Tools of Financial Analysis

Caution When Using DCF Analysis (Rubbish in … rubbish out)

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The Problem with valuations – relative or absolute

Valuation models assume that markets are often inefficient (they get it wrong) but eventually discover 'true' value.

But financial analysts valuations are biased – sign and size of the bias depend on the type of analyst.

And more complicated valuation models are not necessarily more accurate – it's an art, not a science.

Discounted Cash Flow valuation principles

Firm/project value today is the present value of the firm/project's expected cash flows.

Assumes that the firm/project has *intrinsic* value based on its current cash flows, and the growth in and risk of those cash flows.

The analyst estimates:
- effective life of the project/firm
- expected cash flows – properly timed over the effective life
- the right discount rate.

A big ask?

Good things about DCF

DCF is forward looking – better aligned with wealth creation.

DCF focuses on the business operations – requires an understanding of the source and timing of cash flows (revenues and expenses) of the specific project/firm.

DCF is (somewhat) removed from market irrationalities.

What's not so good about DCF

DCF makes many assumptions.

DCF is computationally intensive – when done properly, uses detailed information – that information is not always reliable, and is always noisy (measured with error).

DCF depends crucially on growth and risk assessment.

There is no guarantee that the market value (price) will quickly reflect the DCF value.

What's not so good about DCF

DCF is problematic for projects/firms:

- with current negative cash flows
- without a 'history' of cash flows
- lacking a risk profile (that can be captured by a probability distribution)
- in financial distress
- that are an entirely new business for the firm
- that structurally change(d) business operations.

Rubbish in … rubbish out …

Source List

Slide 7:

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