Introduction to Valuation
Unit 4: Quantitative methods
Lesson 1: Income/cash flow methods

Later-stage companies present their own unique challenges when seeking to pinpoint value. Generally speaking, however, it's easier to ascribe and defend value as a company matures. The opportunity for presenting historic performance data and predicting future performance increases with every fiscal year. Certainly, the application of comparable performance metrics such as income and earnings can be employed as one means. But valuation professionals most frequently use *some* form of income method, focusing on predicting future cash flows from revenue and earnings.

For growth- and later-stage companies, the Discounted Cash Flow Method is most frequently employed. It's usually applied if three criteria are met:

1. A business has a proven track record of reliable incomes and earnings forecasts.
2. A business is expected to experience change and growth.
3. A business is a going concern, meaning it has the income and balance sheet that exceed expenses and liabilities to operate indefinitely.

The Discounted Cash Flow, or DCF, is a methodology used to value an asset based on the net present value of its projected future cash flows. It uses long-term cash flows and includes risk or discount rates to calculate current values of the business. A DCF analysis yields the overall present value of a business (otherwise known as the enterprise value), including both debt and equity.

Discounted Cash Flow valuation is characterized by three main steps:

1. First, we confirm historical financial statements for accuracy.
2. Secondly, we validate all important assumptions for future projections.
3. Third, we sensitize and adjust all variables that influence the projections.

There are a few advantages to the DCF method, such as:

- If assumptions are valid, it is an accurate method.
- Non-economic factors and temporary market conditions do not contribute to the calculated result.
- It is beneficial when comparisons are absent.
- And finally, DCF analysis allows different components of a business, a business unit or subsidiaries to be valued separately.

However, there are also disadvantages, such as:

- The computed values are very sensitive to assumptions, some of which can be subjective in nature.
- And, a DCF model is only as good as its input assumptions.

The steps to complete a Discounted Cash Flow calculation are as follows:

1. **Projections:** Project future cash flows. Use a time period of five to 10 years for your evaluation. Increasing the time period will decrease the probability of your projections.
2. **Terminal value:** Solve using the Terminal Growth Multiple technique or Perpetuity method.
3. **Discount rate:** Calculate the discount rate by using the Weighted Average Cost of Capital value. We can also look at the discount rate as the target return rate sought by investors.
4. **Present value:** Estimate the enterprise value of the organization by discounting the cash flows and terminal values to the present year.
5. **Adjustments:** Deduct the net debt and other adjustments from the enterprise value to obtain the market value.

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