A Closer Look at Terminal Value

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❖ The Terminal Value is a simple way to capture the value of cash flows which occur beyond the time frame of a DCF Model

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❖ There are two approaches:

❖ Perpetual Growth

❖ Exit Multiple

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❖ The Perpetual Growth method is a more academic approach

❖ The Exit Multiple method is more appropriate to real world situations

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❖ As a DCF model normally covers 3-5 years, exceptionally 10, the Terminal Value can make up a significant part of the total valuation

❖ For this reason it is important to understand both approaches

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❖ The Perpetual Model assumes that the company will continue to generate cash flow in perpetuity at a sustainable growth rate

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❖ The formula for the Perpetual Growth Terminal Value is:

❖ TV = Terminal Value

❖ FCF = Free Cash Flow

❖ n = Year 1 of terminal value or final year of model

❖ g = perpetual growth rate of FCF

❖ WACC = Weighted Average Cost fo Capital

❖ $TV = (FCFn \times (1+g) / (WACC - g)$

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❖ The Perpetual Growth rate may actually vary depending on the position of the company in its lifecycle

  ❖ Expansion

  ❖ Maturity

  ❖ Decline

  ❖ It is possible to construct a multi-stage perpetual growth rate model if this is regarded as having a significant impact on the Terminal Value

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❖ The Exit Multiple approach assumes that a sale has taken place at a multiple of a financial metric

❖ The most often cited metric is EBITDA

❖ The Multiple can be any multiple that seems reasonable to the market and appropriate to the company - comparable transactions can give guidance to this

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❖ In practice, you can calulate your model on both bases to establish the range of values generated between them

❖ You can also use the Perpetual Method to derive a comparable Multiple and vice versa, to act as a reality check on your model

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