

Life Spans of Corporations and Terminal Value



Life Spans of Corporations and Terminal Value

- ❖ If we use the Perpetual Growth method to calculate our models terminal value, we are assuming growth in perpetuity
- ❖ But public companies are not surviving as long as they used to

Life Spans of Corporations and Terminal Value

- ❖ 10% of public companies fail each year - up from 2.5% in 1965
- ❖ 5 year company failure rate is 25% to 40% dependent on sector
- ❖ 75% of the S&P 500 firms will be replaced by new firms in the next 10 years

Life Spans of Corporations and Terminal Value

- ❖ In 1970 the average life span of a public company was 50+ years
- ❖ By 2010 this had decreased to around 30 years
- ❖ This does not lead to a sudden termination of cash flows but is more likely to result in a gradual decline in cash flows in the later periods
- ❖ But if our Terminal Value is more than 50% of our valuation, what does this mean for the accuracy of our DCF valuation?

Life Spans of Corporations and Terminal Value

- ❖ We can consider alternatives to the calculation of the Terminal Value in the model

Life Spans of Corporations and Terminal Value

- ❖ Project Finance Approach
- ❖ Assume revenues continue for another 20-30 years and then stop - as they would in an oil well or mine

Life Spans of Corporations and Terminal Value

- ❖ Use the Residual Income Model
- ❖ Value is only added in the later periods if the ROIC exceeds WACC or ROE exceeds cost of equity

Life Spans of Corporations and Terminal Value

- ❖ Discount the Terminal Value more heavily or use a book value or liquidation value instead

Life Spans of Corporations and Terminal Value

- ❖ In summary, be more critical about assumptions in valuation and financial modelling
- ❖ Be prepared to argue against Terminal Values, particularly on financial forecasts over shorter time periods where the TV is a much greater proportion of the value
- ❖ Be cautious about raising these issues if you are attending an interview as they are slightly unorthodox (but valid in my view)

Life Spans of Corporations and Terminal Value

