# The Pros and Cons of the DCF Method

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- You need to apply the DCF method with your eyes wide open
- While it has many advantages, it also has disadvantages too

# The Pros and Cons of the DCF Method

- Whether you are a principal or an adviser, you need to be able to objectively assess the results of your DCF valuation and that means understanding the methods limitations, as well as its advantages

# The Pros and Cons of the DCF Method

- Lets start by taking a look at the advantages of the DCF method…

# The Pros and Cons of the DCF Method

- You can apply a DCF valuation to a wide variety of cash flows, companies, assets and investments
- You only need to be able to identify the cash flows and calculate an appropriate discount rate.
- The terminal value, in the perpetuity model, is a function of the interest rate and an assumed future rate of growth.

# The Pros and Cons of the DCF Method

- DCFs can be applied to different forms of corporate transactions from mergers, acquisitions, capital raising and IPOs

# The Pros and Cons of the DCF Method

- This valuation method is forward looking - comparable transactions for example is based on historic events
- The focus on cash flow generation reduces any distortion from accounting policies, conventions or assumptions

# The Pros and Cons of the DCF Method

- A DCF evaluates the intrinsic value of a business - factors in all the characteristics of the business - is not dependent on peer comparison.
- The focus is on the fundamental expectations of the business but this also takes into account the trading conditions and external factors as cash flow is the final result of the combination of all of these.

# The Pros and Cons of the DCF Method

- DCF analysis allows for different business units or conglomerate companies to be valued separately
- This enables a sum of the parts computation using different operating assumptions and discount rates where appropriate

# The Pros and Cons of the DCF Method

- Once the base case has been established, it is possible to evaluate different scenarios quite easily by changing input assumptions - which impact the cash flow - or the discount rate.
- This permits sensitivity analysis to be performed.

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- A DCF model can be easily constructed in Excel to form the basis for the valuation exercise

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- But we have to consider some of the drawbacks as well…

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- All DCF valuations are only as good as their input assumptions
- In a three statement financial model, these inputs can be very wide ranging and complex

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- This means that DCF analysis is highly subjective and there is always the ability to manipulate the assumptions to derive a required value.

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- One way to counter this is to run a number of scenarios and express the value in a range, rather than in absolute terms.

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- The Discount Rate has a significant impact on the valuation
- As we shall see with the calculation of this rate, again there are a number of inputs which form the discount rate which are subject to judgemental selection.

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- The Terminal Value can represent a very significant percentage of the final valuation and is largely dependent on the growth assumptions (perpetuity model) or the transaction multiple chosen
- These have nothing to do with the intrinsic business assumptions forming the model inputs.

# The Pros and Cons of the DCF Method

- In conclusion, while we recognise that a DCF has its structural limitations, as long as we are aware of these, the methodology is still one of the best ways to arrive at a value or a value range of a company, an investment or an asset.

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