Discounted Cash Flow

Accounting & Finance

Building a DCF, and where the value actually comes from.

Building a DCF.

1. **Forecast free cash flow**
   Operating cash after tax, capex and working capital.

2. **Choose a horizon**
   Long enough to reach a steady state, usually 5-10 years.

3. **Set the discount rate**
   WACC for the firm, adjusted for project risk.

4. **Calculate the terminal value**
   Perpetuity growth or an exit multiple.

5. **Discount everything**
   Each year's flow and the terminal value to today.

6. **Bridge to equity value**
   Subtract net debt from enterprise value.

If terminal value exceeds 75% of the total, the model is really a bet on the terminal assumptions, not the forecast.