Discounted Cash Flow

DCF Pros

- **Cash-Flow Based**: Uses free cash flow (FCF) projections, providing a more reliable measure of financial health by focusing on actual cash generation rather than accounting earnings that can be manipulated. This fundamental approach offers a clearer picture of cash available to investors.
- **Market-Independent**: Valuation remains unaffected by short-term market fluctuations and sentiment, making it particularly valuable during periods of market distortion (bubbles or distress) when comparable valuations may be unreliable.
- **Self-Sufficient**: Functions effectively even without pure-play comparable companies, making it valuable for unique businesses or industries with limited peers. Especially useful when market data or comparable transactions are scarce.
- **Flexibility**: Enables detailed scenario analysis by adjusting multiple variables (growth rates, margins, capital expenditure) to model different future states. The model can be adapted across industries and modified to reflect varying business conditions.
- **Forward-Looking**: Focuses on future potential rather than historical performance, incorporating expectations about future business performance and growth opportunities into the valuation.
- **Reverse DCF Capability**: Can work backwards from current stock price to reveal implied growth rates and assumptions, providing a useful check on valuation reasonableness.

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DCF Cons

- **Dependence on Financial Projections**: Requires accurate forecasting of future performance, which becomes increasingly difficult over longer time horizons. Particularly challenging for early-stage companies or those with limited operating history.
- **Sensitivity to Assumptions**: Small changes in key inputs (growth rates, WACC, exit multiples) can significantly impact the final valuation. The quality of the valuation directly depends on the accuracy of these assumptions ("garbage in, garbage out").
- **Terminal Value Dominance**: Terminal value often represents 50-75% of total valuation, making the model heavily dependent on long-term growth assumptions that are inherently difficult to predict accurately.
- **Assumes Constant Capital Structure**: Basic model assumes unchanging debt-to-equity mix, which may not reflect reality as companies often adjust their capital structure over time. While possible to model changes, it adds complexity and uncertainty.
- **WACC Complexity**: Calculating the appropriate discount rate involves numerous assumptions and methodological choices, each with potential flaws. Cost of equity and debt calculations can be particularly lengthy.
- **Time and Expertise Required**: Building accurate DCF models demands significant time investment and financial expertise, with multiple components requiring careful attention to detail and validation.

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