Discounted Cash Flow

Why Forecast FCFF Instead of FCFE?

While it may seem logical to forecast FCFE, since it represents the cash available to equity shareholders, in most cases forecasting FCFF is preferred due to its operational focus and ability to provide more consistent results that depend far less on a company's capital structure.

Key reasons for FCFF preference include:

- **Simpler Modeling**: Avoids forecasting debt issuances, repayments, and interest expenses.
- **Operational Focus**: Focus on core business operations, not financing decisions.
- **Reduced Volatility**: Cash flows remain stable regardless of large debt issuances and/or repayments.
- **Easier Comparisons**: Facilitates analysis of companies with different debt levels.
- **Valuation Consistency**: FCFF and FCFE DCF models often yield different results due to the compounding effect of leverage assumptions over time.
- **Terminal Value Estimates**: Simpler to select consistent terminal value multiples and growth rates.

FCFE may be preferable only when valuing a company with consistent debt and equity issuance patterns AND predictable repayment schedules, such as:

- Equity-focused real estate investment trusts (REITs)
- Pipeline companies in the oil and gas sector

StableBread

Discounted Cash Flow

Forecast Period Length

FCF is usually forecasted for a period of 5 or 10 years (because they're round numbers).

FCF should be forecasted to a point in the future where the target's financial performance reaches a steady state or normalized level.

Company's Competitive Position	Forecast Period Length
Slow growth; operates in a highly competitive, low-margin industry	1-3 Years
Solid company; has advantages such as strong marketing channels, brand recognition, etc.	5 Years
High growth; operates with high barriers to entry, dominant market position or prospects	~10 Years

Later forecast periods will typically be subject to the most estimation error.

Longer forecast period (10+ years) is often used for businesses in sectors with long-term, contracted revenue streams such as natural resources, satellite communications, or utilities.

- **Why?**: Because contracted revenues or expected production schedules given limited resources are "guaranteed," so you can forecast cash flows until the term(s) end.

StableBread