

Capm and dcfm

Finance



Contrast CAPM and DCF Technique The Capital Asset Pricing Model (CAPM) was developed by William Sharpe and John Litner. The model was introduced in order to assess the level of risk faced by potential investors who are willing to inject their money into any business or project. The basic aim of CAPM is to analyze and evaluate the connection between the risk faced by an investor and the return desired by the investor. The return that the investor requires is reflected through the CAPM. The investor is to be compensated for the riskiness of the venture and the time for which he has been deprived of his invested money i. e. the time value of the money. The more the investment is held, the higher would be the return required by an investor as money loses its value over time (Fama, 2004).

The Discounted Cash Flow (DCF) method on the other hand is a method that is used in order to ascertain the charm of any particular investment. The DCF technique uses cash basis rather than accounting valuation techniques in order to analyze the attractiveness of any particular investment. Hence it considered less subjective because of its cash flow techniques. The cash flows that would be gained from any particular project are discounted using an appropriate discount rate based upon the market rate and the investor's expectations in order to reflect the time value of money. If the value deduced after discounting i. e. the present value is greater than the outflows (usually required at the current time horizon), the project is accepted (Kaplan, 1994).

The CAPM is used to calculate the required return of an investor. This required return is then used as a basis for the DCF method in order to ascertain the Present Value of any given project/investment. The CAPM is used in order to calculate the discount rate and this discount rate is further

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used within the DCF technique in order to value an investment or an asset. The CAPM uses the risk free rate in order to reflect the time value of the money. The market risk premium (i. e. the expected return rate within the market less the risk free rate) is multiplied with the relevant project beta; this project beta denotes the investor's risk (Eugene et al, 2011; Kaplan, 1994).

Usually, companies use the CAPM to ascertain the cost of equity. This cost of equity is further used to calculate the Weighted Average Cost of Capital (WACC) of a firm and finally this WACC is used within the DCF technique in order to calculate the Net Present Value (NPV) of a project/investment. The WACC within the NPV technique denotes the required return of a project (Eugene et al, 2011).

Finally it can be said the CAPM is primarily used before the DCF technique while analyzing the final NPV. The CAPM accumulates all the factors such as risk and the time value of money and finally gives the required return wanted by an investor.

Works Cited

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