

Discounted cash flows methods for asset valuation

[Finance](#)



The most common discount rate employed is the Weighted Average Cost of Capital (WACC), which includes the risk of the cash flows.

Second, some of the Income Valuation methods are “ the capitalization of earnings or cash flows and the discount of future earnings or cash flows” (258). Capitalization is preferred when past operations can best indicate the businesses’ future operations (258). The discount of future earnings is more appropriate when past operations do not reflect future cash flows (258).

Some of the different cash flow methods used are: “ Free Cash Flow, Capital Cash Flow and Equity Cash Flow” (259).

Third, the Free Cash Flow (FCF) refers to what is left from the cash operations after tax is deducted and it does not consider the organization’s debt level, which means that it does not deduct interest expenses (259). For its valuation, the proper discount rate for Free Cash Flows is the after-tax Weighted Average Cost of Capital (WACC), which is computed by using the after-tax cost of debt in the WACC formula (259). Bunea-Bontaş and Petre stress that the Free Cash Flow is a vital measure of the capability of the company to present positive returns to its shareholders. They note that one of the weaknesses of FCF is that since the capital structure of the company is continuously changing, this means that the computation for the WACC must be changed as well (260).

Fourth, Capital Cash Flow (CCF) values the cash flow for all security holders of the company, including debts or shares (260). It adds all cash flows paid or can be paid to capital providers, by measuring all of the assets’ after-tax cash (260). CCF’s present value is equal to the value of the enterprise (260). It uses the discount rate Return on Assets (ROA), which is seen as “ independent of the firm's capital structure” (260).

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Fifth, Equity Cash Flow (ECF) integrates the debt payments (principal and interest) to debt holders for the valuation of the company (260). ECF is the cash that remains with the company after-tax, as well as after paying capital investment requirements, additional costs in working capital requirements, financial expenses, and the principal of the debt, and after obtaining new debt (260). The resultant cash flow is “ net to the equity shareholders” and can be used to pay dividends or share repurchases (260). The cost of equity is a more appropriate discounting rate than WACC for ECF.

Sixth, the Discounted Cash Flow (DCF) determines present company value by computing future cash flows and discounting them at rates that match the flows’ risks (261-262). It is considered as the “ conceptually correct valuation,” because it contains comprehensive and careful forecasts for each period (262). Bunea-Bontaş and Petre argue that DCF is the most appropriate cash flow method because of its simple calculation methods (262). The DCF can offer an accurate valuation of company assets, but this still depends on using the proper discount rate that will be used to estimate future cash flows. The discount rate used is frequently the suitable WACC that replicates the risk of the cash flows, associated with the “ time value of money” and “ the investors extra-compensation demand” (263).