How to Sanity-Check Your DCF

• Question that came in the other day…

• “I need your help. I didn’t get a chance to go over the entire course yet. I am working on a DCF (Discounted Cash Flow) model and need to make sure my model is error-free.”

• “Are there any sanity checks I can do? Or any simple ways of making sure my model isn’t wrong?”
• What is “wrong”? Not like a math problem with an incorrect answer… BUT

• There are some common problems you want to avoid in a DCF

• Long Version: Could spend hours talking about this

• Short Version (Here): 3 Simple Rules for What to Avoid
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• **Problem #1:** How much of the company’s Present Value comes from the PV of its Terminal Value?
  ▪ Should *ideally* be 50-60% or less
  ▪ Above that is not the end of the world, but if it’s 80-90%, why even bother with a DCF?

• **Problem #2:** Do the Implied Long-Term Growth Rate and the Implied Terminal Multiple make sense?
  ▪ LT growth rate of 10%, but GDP growth of 3%...?!!!
  ▪ Implied Multiple of 10x, but comps trade at 8x...?!!!
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• **Problem #3:** Are you double-counting items?
  - **In FCF:** Leave out of Implied Enterprise Value → Equity Value calcs at the end
  - **NOT in FCF:** Include in Implied Enterprise Value → Equity Value calcs at the end
  - **EX:** Interest Expense → If you leave it out (Unlevered FCF), you **DO** want to subtract debt at the end when moving from Enterprise Value to Equity Value
How to Fix a Broken DCF

• **Fix #1:** Extend the projection period to 10-15 years instead → 5 years is often too short!

• **Fix #2:** Reduce the Terminal Value by using a lower long-term growth rate or a lower terminal multiple

• **Fix #3:** Increase the Discount Rate → Will impact the Terminal Value more in most cases and reduce the contribution from the PV of the Terminal Value