Levered Free Cash Flow and the Levered DCF: The Most Useless Valuation Methodology?

How to Go Down a Rabbit Hole Without Finding Any Rabbits…

Levered FCF: The Most Common Questions…

"Should I use a Levered DCF or Unlevered DCF to value a company?"

"Which one is 'better'? Do they produce equivalent results?"

"How do I set up the assumptions in a Levered DCF?"

Levered FCF: My Biased Opinion

It's a **waste of time** to think about or use Levered FCF in ~99% of real-world scenarios.

You need to know the basics for interviews, but at banks/other finance firms and in your own investing, it's quite rare.

Levered FCF: My Biased Opinion

To get all the files, resources, screenshots, and a text version of this tutorial, go to:

https://breakingintowallstreet.com/kb/valuation/levered-free-cash-flow/

Lesson Plan / Outline:

- **Part 1:** Basic Definition of Levered FCF and Excel Demo **2:10**
- **Part 2:** Changes Required in a Levered DCF Analysis **5:10**
- **Part 3:** U.S. GAAP vs. IFRS Differences for Levered FCF **10:44**
- **Part 4:** Why the Levered and Unlevered DCF Are **Not** Equivalent **12:53**
- **Part 5:** Is Levered FCF *Ever* Useful? **16:57**

What is **Levered Free Cash Flow**?

- **Basic Idea:** Levered FCF, also known as Free Cash Flow to Equity (FCFE), represents **cash flows to equity investors (shareholders)** rather than all investors in the company

- **Formula:** Net Income to Common + Depreciation & Amortization +/- Deferred Taxes +/- Change in Working Capital – Capital Expenditures +/- Net Debt Borrowings

- **Main Differences vs. Unlevered FCF:** Deducts Net Interest Expense and Preferred Dividends and “factors in” Other Income/Expense and Debt Issuances and Repayments

What is **Levered Free Cash Flow**?

- **Your Thinking:** "Wait, isn't this what we *want*? The goal of a valuation is to determine how much a company's **shares** are worth, so why not use a methodology that values the shares directly?"

- **But:** Doing this requires *substantial* extra work, changes throughout the analysis, and pure guesswork on many of the additional assumptions

- **And:** Even if you get all that right, a DCF based on Levered FCF still produces <u>less consistent</u> results than a standard Unlevered one

What **Changes** in a Levered DCF?

- **Discount Rate:** Cost of Equity rather than WACC

- **Line Items:** Subtract the Net Interest Expense and, if applicable, Preferred Dividends and Other Income/Expense; also factor in Debt Issuances and Repayments

- **Terminal Value:** Use P / E or other Equity Value-based multiples rather than TEV / EBITDA

- **Ending Calculation:** The DCF produces the Implied Equity Value directly; no need to "back into it" using the Enterprise Value bridge

What **Changes** in a Levered DCF?

- **Shift the "Bridge" to LFCF Line Items:** Any Asset or Liability in the bridge of an Unlevered DCF must factor into the LFCF numbers directly now!

- **Examples:** Cash → Add Interest Income; Debt → Subtract Interest Expense and Add/Subtract Issuances/Repayments

- **Others:** NOLs → Tax Savings from NOLs; Preferred Stock → Preferred Dividends; Unfunded Pensions → Entire Pension Expense (the list goes on)

- **Also:** There's no way to treat convertible bonds properly!

U.S. GAAP vs. IFRS Differences in LFCF

- **Main Difference:** Once again, related to our old friend: **lease accounting** and how it's confusing in the post-2019 world

- **Key Point:** You *must* subtract the entire Lease Expense for both Operating and Finance Leases, regardless of whether it's "Rent" or Depreciation & Interest, because there's no bridge!

- **So:** Subtract Lease Interest and Lease Depreciation from the IS, and <u>do not add back the Lease Depreciation</u>

- **No Disclosure:** Could also add back the entire Depreciation line and subtract Lease Principal Repayments

Why the Unlevered DCF <> the Levered DCF

- **QUESTION:** "OK, OK, so the Levered DCF takes more work and requires more assumptions, but shouldn't it at least produce results similar to those of an Unlevered DCF?"

- **ANSWER:** No! Depends on meaning of "similar," but you'll often see differences of 10-20%+, which can make a difference in stock picks and client recommendations

- **WHY:** Short answer is that it's very difficult to reflect all the items formerly in the Enterprise Value bridge in an "equivalent" way in the LFCF projections

Why the Unlevered DCF <> the Levered DCF

- **EX:** If the interest rate on Debt rises from 5% to 10%, that affects every single Levered Free Cash Flow, perhaps quite substantially

- **But:** It only makes a small impact on the Market Value of Debt in the "bridge" in an Unlevered DCF

- **Also:** More "volatile" FCF due to Debt Issuances / Repayments

- **And:** It's difficult to pick Terminal Multiples that are consistent, imply reasonable terminal growth rates, and line up with the Unlevered DCF output

Levered DCF: The Bottom Line

- **Problem #1:** More time and effort because you need the Cash and Debt balances, Net Interest, changes in Debt, etc.

- **Problem #2:** More "volatile" FCF numbers because large Debt issuances and repayments could distort the results

- **Problem #3:** It's very difficult to pick assumptions that produce results equivalent to those of an Unlevered DCF

- **Problem #4:** There's some disagreement about how to calculate Levered FCF (All Debt repayments? Only mandatory payments and maturities? What about new Debt issuances?)

Levered DCF: The Bottom Line

- **Is It Ever Useful?** You'll sometimes see it used for equity REITs because it's easier to predict Debt and Equity issuances there

- **Also:** Potentially useful in restructuring/bankruptcy scenarios or other cases where the capital structure changes a lot

- **Also:** Levered FCF can potentially be a screening tool to find LBO or acquisition candidates, but it's not "better than" normal Free Cash Flow

- **But:** In ~99% of cases, you should not spend more than a few seconds thinking about it before remembering it's a bad idea

Recap and Summary

- **Levered DCF:** Project *cash flow to equity investors* by subtracting the Net Interest Expense and factoring in Net Borrowings

- **Discount Rate:** Cost of Equity rather than WACC

- **Terminal Value:** P / E rather than TEV / EBITDA; no "bridge" since you calculate Implied Equity Value directly

- **Many Problems:** Much more time and effort, volatile numbers, difficult to forecast Changes in Debt, calculation disagreements, and no real advantages over UFCF-based DCF