Discount Rate Myth 2: It's all about the D in DCF

The Focus on Discount Rates

- In both academia and practice, there is far more attention paid to discount rates than to the estimation of cash flows.
- In academia, this focus can be traced to the fact that it is far easier to build theory and general models for discount rates than cash flows.
- In practice, the focus can be traced to
  - An over estimation of the impact of discount rates on value. (The Gordon Growth Model Effect)
  - A need for control

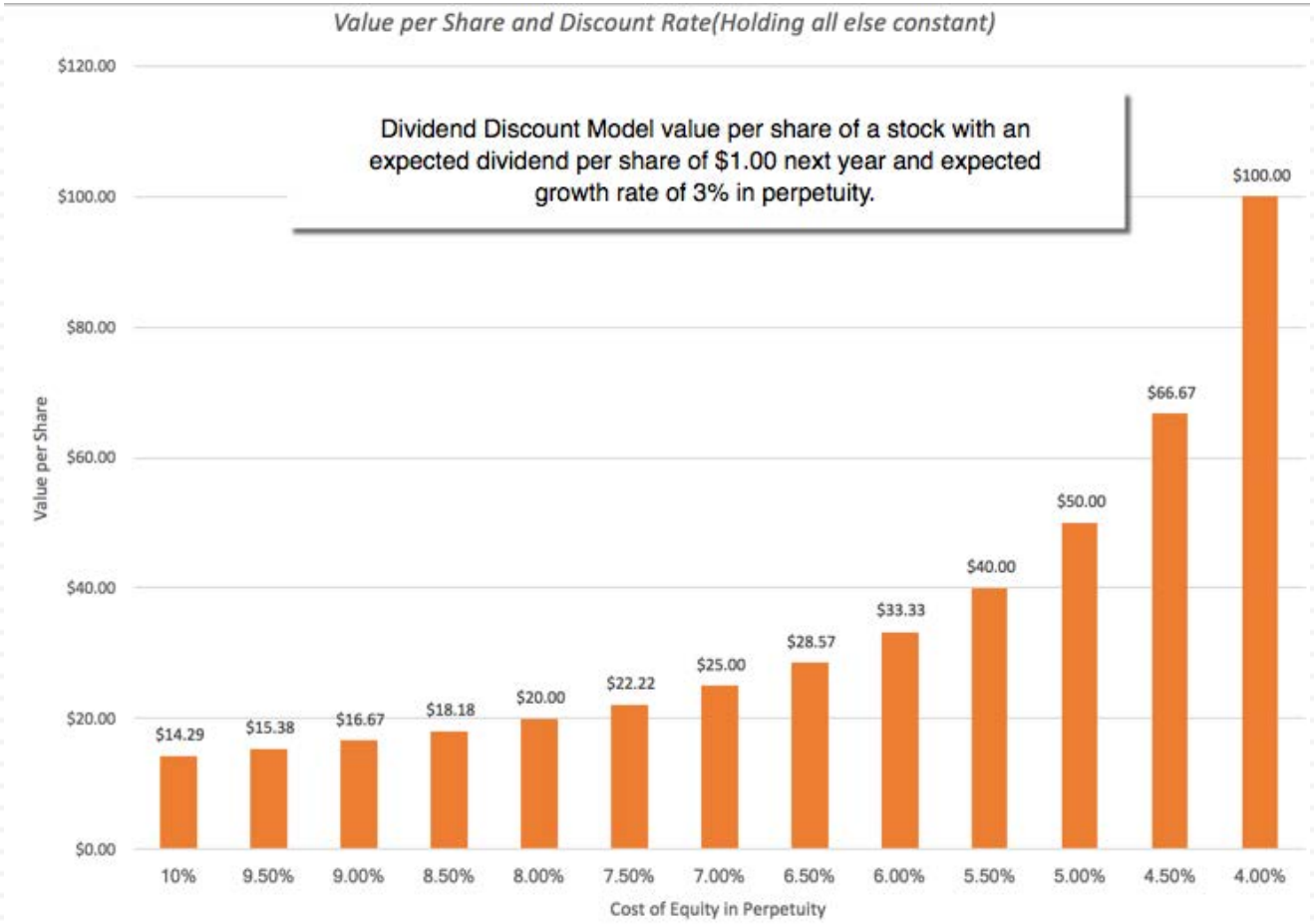
1. The DDM Effect

- At the root of DCF is the Gordon Growth Model, a model designed to value a mature company that pays out all excess cash flows as dividends.

$$Value\ of\ Stock = \frac{Expected\ Dividends\ next\ year}{(Cost\ of\ equity - Expected\ growth\ rate)}$$

- In this model, the dividends are given, the expected growth rate is an exogenous input and not surprisingly, small changes in the discount rate translate into big changes in value.

A Simple Illustration

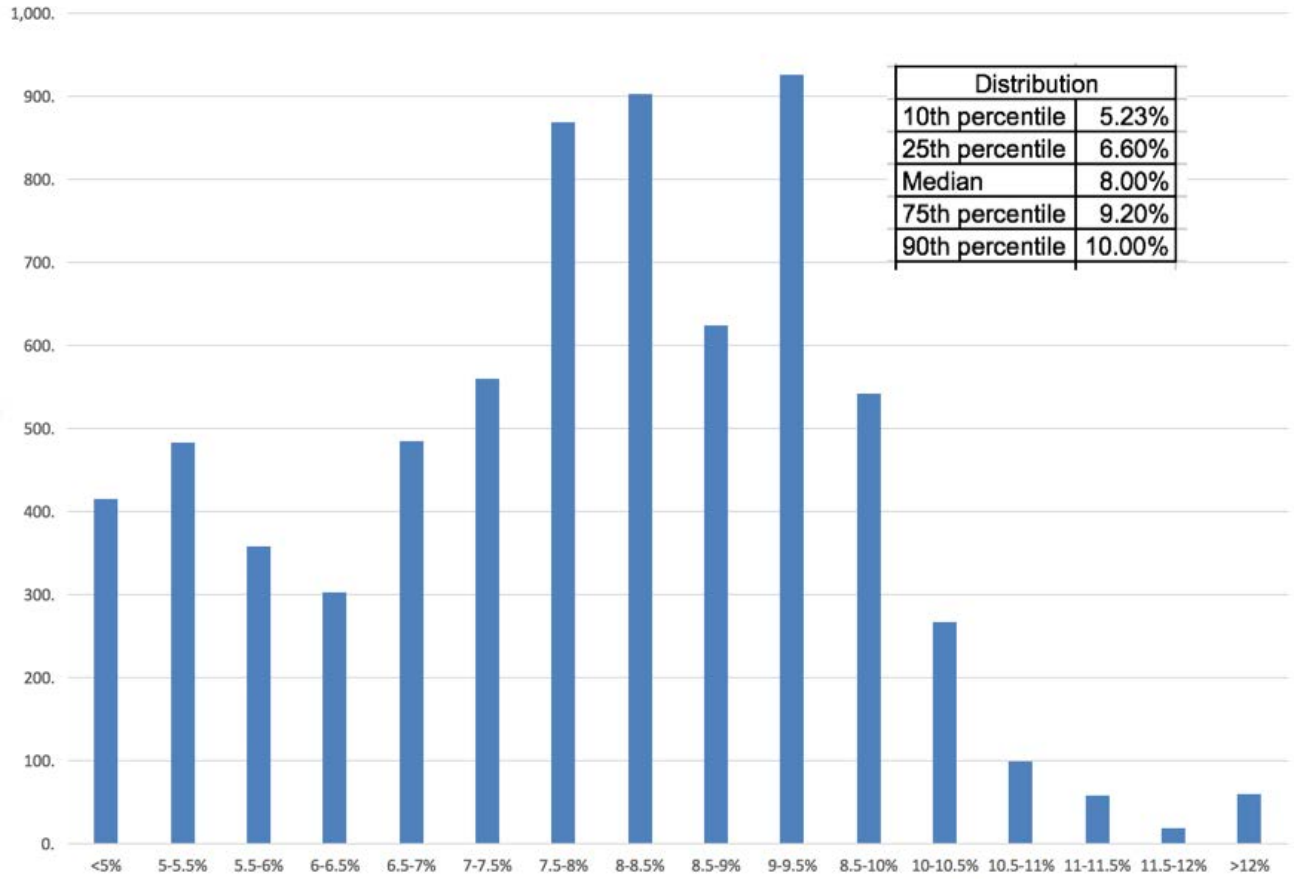


Reason 2: Control

- When faced with significant uncertainty in valuation, it is comforting to turn our attention back to discount rates, where we can draw on established models and data to estimate and fine tune the components (risk premiums, betas, costs of debt).
- Estimating risk free rates, betas and equity risk premiums to the second, third or even fourth decimal points offers the illusion of control in a world where estimates of revenue growth and operating margins are difficult.

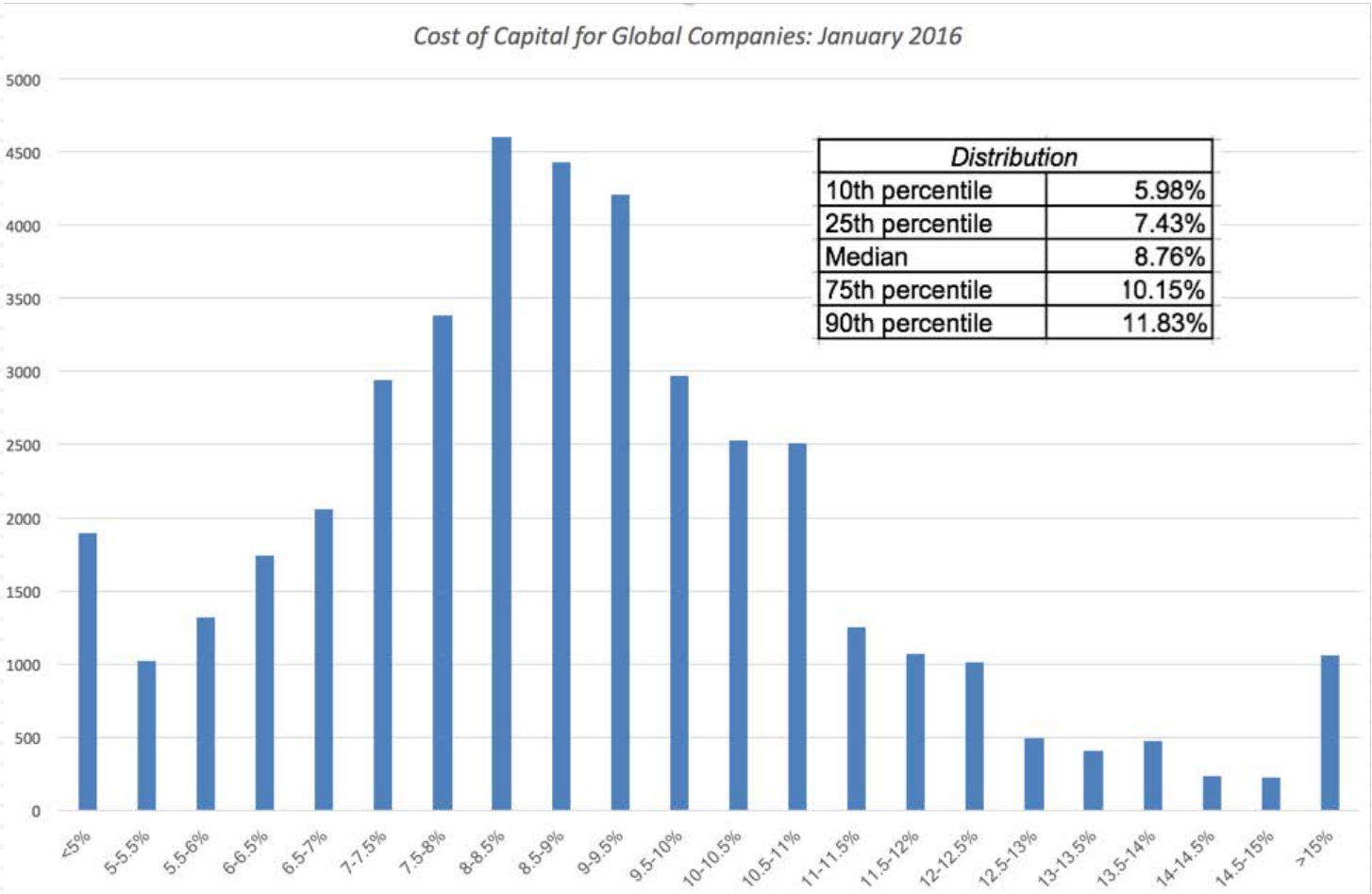
Not much room to be different.. US company cost of capital in 2016

Figure 16: Cost of Capital for US Companies - January 2016



Distribution	
10th percentile	5.23%
25th percentile	6.60%
Median	8.00%
75th percentile	9.20%
90th percentile	10.00%

The Global Analog



Distribution	
10th percentile	5.98%
25th percentile	7.43%
Median	8.76%
75th percentile	10.15%
90th percentile	11.83%

The Bottom Line

- It is the cash flow: When you make big mistakes in valuation, it is almost always because you got the cash flows wrong, not the discount rate.
- Especially for younger companies: It is particularly true for younger companies and in the face of uncertainty about the future. Instead of spending most of our time during valuation
- A Suggestion: If you have to value a US company in a hurry, why not just use a cost of capital of 8% in July 2016, the median value for US stocks, and spend your limited time on the numerator (cash flows)?