

## ASPECTS CONCERNING THE DETERMINATION OF THE COMPANY VALUE USING THE DCF METHOD

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**Abstract:** *The objective of this paper is to understand the logic of the income approach and of one of the methods comprised in this approach, more specifically, the importance, advantages and disadvantages of the application of the DCF method for the determination of the company value.*

**Key words:** DCF method, valuation, accounting, company


**JEL Classification Codes:** D46, G32, M40.

### 1. INTRODUCTION

It is obvious that in the current economic context, there are a multitude of purposes for which company valuation is carried out, generated by the needs of the various users of information to know its value. Basically, company valuation is requested for information or trading purposes. According to prof. Toma M.'s opinion (2009), the full or partial valuation of a company consists of determining the most probable area of the price for which a transaction could be concluded under normal circumstances. At the same time, the opinion according to which the determination of the company value is based only on its net worth at the moment of its valuation is wrong because, in addition to it, its potential to increase its wealth in the next period should also be taken into account. This means that "company valuation does not only represent the determination of the value of properties or goods from its assets, but also the determination of the ability of the company to generate flows (profit, cash-flow etc.) available to its owner, given that the valuated object (the company) is an asset that has the ability to create assets" (Anghel I, 2010). This logic stems from the fact that potential investors and other users of the information are more interested in the ability of the entity to generate profit or to create cash flows rather than the value of the net asset of the company at a given moment. Taking this strong argument onto account, the methods comprised in the income approach are very often applied in the in the company valuation practice, being strongly supported by both sides involved in the valuation missions. The valuation method constituting the object of study of this article and is included in this approach is one of the most frequently used company valuation methods and is based both on the history of the activity of the company as well as on its future forecasts.

### 2. MATERIALS AND METHODS

As shown in the guides on the research methodology (Andone I., Georgescu I., Toma C., 2011) the research in a specialised area, including the valuation area, is motivated by:

 The need to understand phenomena, events, transactions and processes specific to the area in question. Such research is called pure or fundamental research;

- ☞ Finding a solution to a problem/question/request of a customer. This is a research oriented towards a certain purpose (instrumentalist research);
- ☞ Finding a solution necessary for an applicative field (applied research);
- ☞ Studying the existent practice in that area (action research).

In our opinion, our paper falls both into the category of the fundamental research, as well as in that of the research of the existent practice in this area. This article is based on qualitative and quantitative research methods (research of the practice in the area, case study research, examination and phenomena measuring methods), and among the data sources, we are mentioning: the observation of the phenomena, documents and texts, impressions and reactions of the researchers (authors).

### **3. OPPORTUNITY OF THE APPLICATION OF THE DISCOUNTED CASH FLOW METHOD**

In order to understand the legal framework of company valuation in Romania, as well as the valuation standards and methods applied, we naturally ask ourselves the first questions: what rules/guidance/standards are applied for the company valuation and if there is a tendency to harmonize them taking into account the internationalization of transactions, the free movement of people and certain goods? As for the Romanian accounting, the IFRS (International Financial Reporting Standards) represent a reference of financial reporting at international level, the same “harmonization” was desired in the valuation area as well, as there are references both at international level through the International Valuation Standards (IVS), as well as at national level, through the valuation standards of ANEVAR (the National Association of Romanian Valuers), which are mandatory for carrying out the valuation activity. In Romania, the IVS valuation standards were kept (but not as exclusive standards), as well as part of the European Valuation Standards (EVS), as well as valuation guides (GEV), all of them forming the collection named “ANEVAR Valuation Standards”. This collection of standards that are updated yearly comply both with global rules, as well as regional and national rules, being adapted to the current realities of the specific national and international market.

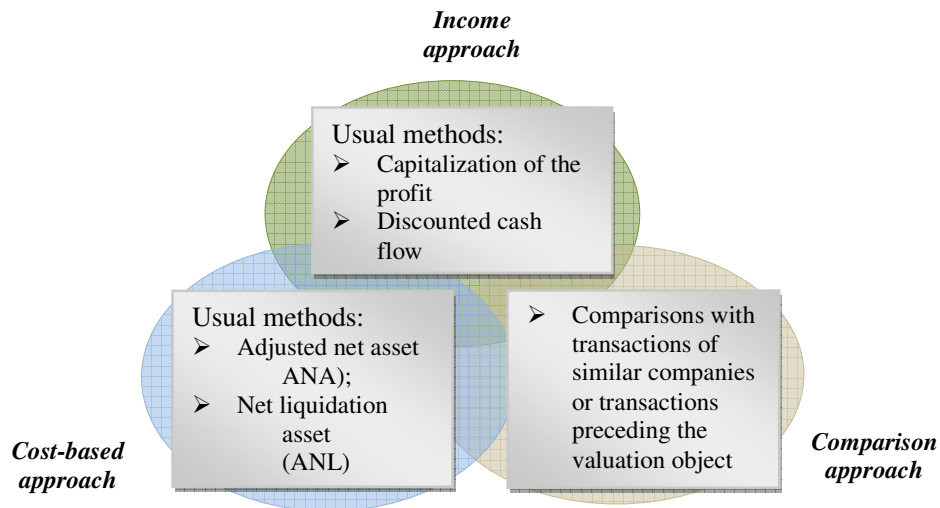
In the theory and practice of valuation, several company valuation methods are known. Up to the actual moment when the method is applied, other steps of the valuation process are completed as well, starting from the definition of the problem (including the specification of the valuation bases and limits) and continuing with the global company diagnosis. The purpose of diagnosis a company for valuation is to understand all its activities, more specifically the legal, commercial technical, human resources, and financial one, as well as the strengths and weaknesses of each of them. Its goal is to highlight the company operation parameters, assess its performance and the risks of the future business, and other information that can guide the valuator’s reasoning in applying the valuation method in the next stage.

The valuation practice standard directly related to the company valuation clearly specifies that the selection and support of the adequate approaches, methods and procedures depends on the valuator’s professional reasoning. The valuator must present the reasoning and justification for the methods used and for the importance given to the methods which resulted in the final value. The selection of the most adequate valuation approach or method depends on:

- ☞ The purpose of the valuation;
- ☞ The availability of input data and information for valuation;
- ☞ The approaches or methods used by the participants to a relevant.

The valuation approaches are families of valuation methods that have common perspectives of viewing value. Even if there are a lot of opinions according to which there are a multitude of valuation approaches, in reality, this “multitude” comprises three approaches that

are known and recognized, namely: the market approach, the income approach, and the asset approach (Vascu A., 2015).



**Figure 1 Valuation approaches used**  
 Source: diagram drawn up by the authors

According to the valuation standards, for the valuation of a company or of the participants to its equity capital, the market and income approaches can be applied. In the case of certain types of companies, their value can be obtained by adding up its assets and its liabilities. This is sometimes referred to as net asset or asset approach, without being recognized, however, as an actual approach in company valuation. Certain specialists consider that it could be identified with the cost approach that groups the valuation methods used for certain assets.

The market approach is a pragmatic way to value businesses, essentially by comparison to the prices at which other similar businesses or business interests changed hands in arm’s-length transactions (Pratt S., 2008).

According to IVS “Framework”, *the income approach* is defined as being a valuation approach that “provides an indication of value by converting future cash flows to a single current capital value”. This approach is based, first of all, on the principle of anticipation which says that “value arises by means of anticipated benefits to be derived from a property in the future”. In the use of the income approach, various methods are used for the assessment of value. The two usual methods are: the capitalization of cash flow method and the discounted cash flow method (also abbreviated as the DCF method from the English Discounted Cash Flow Method).

As highlighted in the Valuation Guide concerning the “Discounted Cash Flow” (International Valuation Standards Council- IVSC-2012), **the DCF method** can be used to assess most assets generating cash flows. If a company is valued, it is viewed as being able to provide a better opinion on value than other methods, if:

- ✳ The company benefits from a significant growth or has not yet reached the maturity stage of its business, for example, a new company or a real estate investment under construction;
- ✳ Cash flows are susceptible to fluctuate from one period to the next, in the short term, for example the fluctuations of the income of a company due to cyclical changes in the demand for its products, or
- ✳ The company has a limited duration, for example, companies in the natural resources energy sector.

Unlike the DCF method, the capitalization of the income method is applied only if the valuated company reached the stage of economic stability, characterised by the following features (Stan S., Anghel I. -coord-, 2016)

- ✱ The rate of return of the invested capital reaches the average rate of return obtained in the business area in question;
- ✱ The allocation of a constant share of the net profit to investments, i.e. the annual capital investment is equal to the annual amortization and the net cash flow is approximately equal to the net profit;
- ✱ The annual representative and sustainable cash flow is expected to be of the nature of a constant annuity or a perpetually growing annuity with a constant compound annual rate (symbolised by g).

We should mention that, due to safety and accuracy reasons in the determination of the final value of the entity, the valuator applies several valuation methods, falling within different approaches. The reconciliation of the value and the assessment of the final value is the last stage of the valuation process, and the professional valuer will carry out a systematic analysis of the results obtained by applying the methods and will objectively select only one of them, based on his professional judgement.

#### 4. METHODOLOGY OF THE DETERMINATION OF THE COMPANY VALUE BY APPLYING THE DCF METHOD

As highlighted in the Valuation Guide 1 “Discounted Cash Flow” (International Valuation Standards Council- IVSC-2012), the DCF method leads to obtaining an opinion on value, by discounting the forecasted cash flows, on the day of the valuation, resulting in a present value of the company. Then a terminal value is determined, at the end of the explicit forecasting period, which is updated at the day of the valuation in order to obtain the total company value. If the company has assets outside the operation, such assets are separated from the other assets, they are assessed separately at the net realizable value, and their value is added to the value of the company determined using the formula below.

The formula used in the case of this method, with the purpose of determining the company value, is:

$$V_{DCF} = \frac{CFN_1}{(1+k)^1} + \frac{CFN_2}{(1+k)^2} + \frac{CFN_3}{(1+k)^3} + \dots + \frac{CFN_n}{(1+k)^n} + \frac{V_{ter}}{(1+k)^n} + VRNAAE \quad (1)$$

where

VDCF - company value (value of the invested capital);

CFN<sub>1</sub> – net cash flow, corresponding to the first year of the explicit forecast period;

CFN<sub>2</sub> – net cash flow, corresponding to the second year of the explicit forecast period;

CFN<sub>n</sub> - net cash flow, corresponding to the last year of the explicit forecast period;

k- discount rate (the cost of capital);

V<sub>ter</sub>- terminal value of the company at the end of the explicit forecast period

n – number of years of the explicit forecast period;

VRNAAE – net realizable value of assets outside the operation.

A brief mathematical expression of the formula is:

$$V_{DCF} = \sum_{i=1}^n \frac{CFNi}{(1+k)^i} + \frac{V_{ter}}{(1+k)^n} + VRNAAE \quad (2)$$

For the application of the DCF method, the following **main input data** are required:

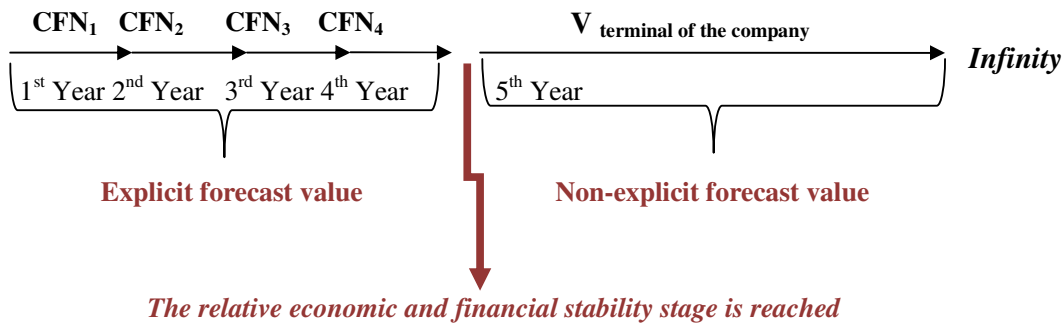
- The determination of the explicit period for which the cash flows will be forecasted;

- The cash flows forecasted for the period in question;
- The value of the company at the end of the explicit forecast period, i.e. the terminal value;
- An adequate discount rate which is applied to the future forecasted cash flows, including to the terminal value.

## 5. PROBLEMS AND SOLUTIONS RELATED TO THE APPLICATION OF THE DCF METHOD

### ➤ The determination of the explicit period for which the cash flows will be forecasted

As we specified in the description of the method, cash flows are forecasted by the valuator separately for each year in the time period referred to as explicit, and at the end of the last year of this period to infinity, referred to as non-explicit period of time, the terminal value of the company is assessed. For example, if the explicit period of time would include 4 years, as emphasized in the figure below, the net cash flow (NCF) is forecasted in each of the four years while from the fifth year to an indefinite period in the future (which tends to infinity) the terminal value of the company is calculated.



**Figure no. 2 Division of the future period of life of the company from the perspective of the cash flow value/terminal value forecast**

Source: diagram drawn up by the authors

There are various recommendations in this field related to the selection of the period of time when cash flows will be forecasted for each year, or to the selection of the explicit period of time, respectively. Stan S. and Anghel I. (2016) consider that the duration of this period is between 5 and 10 years, and Toma M.(2009) considers that "the projection of the net cash flow should be made on a period as long as possible, but compatible with the company's forecast horizon".

As can be inferred from the guidance of the specialised materials published on company valuation (Iroval, 2015 and IVSC, 2012) and as proved by the practice, the following aspects can be retained for the selection of the explicit forecast period:

➤ This period must be determined based on factors reflecting the specific situation of the company on the day of its valuation. If there is a business continuity, at the end of this period, the company constituting the object of the valuation mission should have a rate of return on equity and/or a rate of return on invested capital equal to the cost of equity and/or the weighted average cost of the company's capital.

Where The rate of return on equity 
$$ROE = \frac{\text{Net profit}}{\text{Equity}} \times 100 \quad (3)$$

$$\text{The rate of return on invested capital} = \frac{\text{Profit before taxes and interest}}{\text{Invested capital (or total assets)}} \quad (4)$$

The information related to how the cost of equity and the weighted average cost of the company's capital are calculated will be shown in other sections of the research paper.

- In the case of a new company, the explicit forecast period comprises the time required by the company so it can reach a stable operational and financial level which can provide an adequate rate of return of the investment made.
- The evolution of the financial variables based on which the net cash flow is calculated can influence the division of the explicit forecast period into two evolution stages (the first one of rapid growth, and the second of decrease in the growth) or, on the contrary, to identify a single stage, that of rapid growth.
- If obtaining the net cash flows is significantly influenced by the existence of concession contracts, rental or leasing agreements related to the main equipment, then for the companies in question, the explicit forecast period will be determined based on the contractual provisions concerning the aspects presented at this point.
- As we know, one of the purposes of the overall company valuation is to determine its value in the case of its reorganization through merger. In such case, the explicit forecast period must cover the period of time required to integrate and show the union effect of the merger.

**In conclusion, the selection of the explicit forecast period is influenced by several factors, namely the type of the valuated company, the purpose of the valuation, the type of required value, the available information, the place occupied on the life curve, the variables influencing the calculation of the cash flows and their forecast evolution, the limited or unlimited duration of the company (for example in the case of the valuation of a company operating in the natural resources recovery field, with a limited duration, the forecast of net cash flows will be made for the entire duration).**

#### ➤ **The cash flows forecasted for the respective period**

In the Valuation Guide 1 "Discounted Cash Flow", cash flow is defined as follows: "The cash that is generated on a period of time by an asset, a group of assets or a company".

In the company valuation methodology, two types of cash flow are used:

1. The net cash flows available to shareholders (NCFTE);
2. The net cash flows available to the company (ICNCF).

The International Valuation Standards defines the two types of cash-flow:

- Net cash flow to equity (NCFTE): net income plus depreciation and other non-cash charges, minus capital expenditures, minus increases in the working capital, minus decreases in the borrowed capital invested (NCFTE represents the dividends payable to shareholders). If this type of cash-flow is used, the value of the company will be determined in the form of shareholders' capital, or the equity market value respectively.
- Invested capital net cash flow (ICNCF): the net cash flow to equity, plus paid interests, after tax, minus net increase in the borrowed invested capital (ICNCF represents the total resources required to cover the debt service and for the dividends payable to shareholders). If this type of cash flow is used, the value if the company will be determined in the form of the value of the invested capital, i.e. the overall value of the company.

The following relationship exists between the two types of cash flow:

<b>Value of the shareholders' capital</b> (Equity market value)	<b>= Value of the invested capital</b> (Company value)	<b>- Net loan market value</b> (the difference between total loans and the cash or cash equivalents available to pay such debts)
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*Naturally, we can ask ourselves when is it best to use ICNCF/NCFTE?* In our opinion, the use of NCFTE is helpful when the annual debt service is not significantly different from one year to the next, within the explicit forecast period and due to the fact that it requires to calculate interests payable throughout this entire period, there must be detailed, logical and homogeneous hypotheses concerning the financial structure. For these reasons, ICNCF is mostly used when the conditions are not met for the use of NCFTE, implying, however, data concerning the company financing (the calculation of the share of the loan and that of the equity in the total invested capital) for the determination of the weighted average cost of capital (WACC) which can reflect the discount rate. The type of forecasted cash flow depends in the nature of financial information available for forecasting as well as the practice on the respective company valuation market.

In relation to the method of calculating the two types of net cash flow, we are mentioning that there are several calculation formulas, as they can be determined starting from the EBIT (earnings before interest and tax) or EBITDA (earnings before interest, taxes, depreciation, and amortization). We will present, in the table below, one of the methods of calculating the two types of cash-flow:

**Table nr. 1 Method of determining NCFTE and ICNCF**

<p><b>Normalised earnings</b>                      + Depreciation and other non-cash expenses                      - <b>Capital expenditure (required for the achievement of the turnover and the forecasted expenses)</b>                      - <b>Increase in the net working capital NWC (required for the achievement of the turnover)</b>                      + <b>new loans accessed (required for the achievement of the forecasted turnover)</b></p>	<p><b>Normalized net operating profit</b>                      + Depreciation and other non-cash expenses                      - <b>Capital expenditure (required for the achievement of the turnover and the forecasted expenses)</b>                      - <b>Increase in the net working capital NWC (required for the achievement of the turnover)</b>  <i>Or</i>  <b>Normalised earnings</b>                      + Depreciation and other non-cash expenses                      + Interest paid (<b>1- profit tax rate</b>)                      - <b>Capital expenditure (required for the achievement of the turnover and the forecasted expenses)</b>                      - <b>Increase in the net working capital NWC (required for the achievement of the turnover)</b></p>
<p>= Net cash flow to equity (shareholders) (NCFTE)</p>	<p>= Invested capital net cash flow (investors) (ICNCF)</p>

Source: authors' own work based on specialised literature

How will ICNCF/NCFTE cash flows be expressed? For the explicit forecast period, cash flows are determined by using the forecasted financial information (FFI), i.e. the estimated income (cash inflows) and expenses (cash outflows). The cash flow forecasting should take into account the scenario of the future evolution of the valuated company, of the field of activity and of the economy as a whole. The valuator will base his judgement on a context of normal continuity of the activity in which the responsible people will try to achieve their performance increase objectives while making the most effective use of the involved production factors. The cash flow model must be built in such a way as to adequately capture future scheduled planned events, for example, the new contracts concluded with the beneficiaries, strategies of opening working points, or new manufacturing divisions, schedules for commissioning new technological lines, termination of contracts, reviewing contracts or future forecasted events that are expected to trigger changes in the cash inflows and outflow, when they are expected to appear.

*How/where will the valuator obtain the values of the items comprised in the calculation of the cash flows?* Some of the hypotheses, such as those related to the capital expenditures or the change in the net working capital, can be accurately assessed only by specialised managers of the valuated company. The company managers/owners supply most of the information related to

business plans, restructuring, internal marketing studies, financial statements, etc. The valuator also uses the conclusions of the overall diagnosis drawn up by him in the stage preceding the actual valuation and also specialised studies or various magazines/publications/ statistical macro and microeconomic situations.

Each item included in the determination of the net cash flow is forecasted in a different manner, depending on the available characteristics and information. For example, the sales forecast, or the forecast of the turnover (T) is viewed as having the utmost importance for forecasting the other indicators composing the cash flow. We assume that, in the valuation of the company Sortilemn SA, one of the most important and effective companies in Romania operating in the furniture field, a potential valuator will include, in March 2016, in the evolution scenario, the hypothesis according to which the turnover will grow by 3% in the first three years and by 1.5% in the last 2 years of the explicit forecast period (the economic development stage of the company is disregarded, the purpose being to highlight an area with stable evolution characteristics and products already present in the market).

**Table no. 2 The assessment of the turnover**

Explanations	2015	2016	2017	2018	2019	2020
Turnover annual growth		3%	3%	3 %	1.5 %	1.5 %
Turnover (lei)	181,199,388*	186,635,369	192,234,430	198,001,463	200,971485	203,986,057

\* <http://www.date-financiare.ro/199745-sortilemn-sa>

Source: authors' own work

If we ask ourselves how the potential valuator forecasted the turnover, then we should highlight a few important aspect that support the judgement of the valuator in this approach. First of all, the type of market characteristic to the valuated company is analysed, as follows:

*-if the market specific to the valuated company is unstable or if there is few information in the market (products/technologies placed on the market), the forecast is deemed as being hard to carry out in the long term, and qualitative methods are used.* Such methods are based on the valuator's thinking concerning the potential evolution of the analysed indicators, taking into account the vision of those involved in the management of the entity and the recent economic changes. Out of the qualitative forecast methods known in the specialised literature we would like to mention: the educated supposition method, the consensus of a group of top managers, the Delphi method, a study at the sales department method, market research, building scenarios.

*-if, on the contrary, the market/field in which the valuated company operates has a stable evolution and there are historical data available concerning the analysed economic indicators, se quantitative forecast methods are used.* Such methods are based on the hypothesis according to which the factors that determined the demand in the past for the products/services of the company will also determine the future one. In such case, the forecast of the incomes related to the turnover is carried out by means of models for time series (which imply the fact that the valuer should have robust statistics, Excel and econometrics knowledge). Consequently, in the case of the hypothetic forecast of the turnover for the aforementioned company, it is recommendable to use quantitative forecasting methods.

#### ➤ **Company value at the end of the explicit forecast period and the determination of an adequate discount rate**

As we presented the formula for the determination of the company value in the case of the application of the DFC method, it is also necessary to calculate the terminal (residual) value of the company, defined in the Guide on Valuation 1 Discounted Cash Flow as being the "value



at the end of the explicit forecast period of all cash flows forecasted after this period”. Starting from the fact that it is considered that in many cases, the discounted terminal value has a high share in the final value of the company, deemed to be between 50% and 80% (Stan S. and Anghel I., 2016) we can conclude that the method of calculating the terminal value has a major impact on the reality and the credibility of the final value attributed to the company.

The method of calculating the terminal value varies depending on the continuity or, on the contrary, the cessation of the activity of the company at the end of the explicit forecast value. If the company ceases its activity, the adequate method of determining the terminal value is the Net Liquidation Asset (the value of the debts to be paid in case of liquidation, including to the liquidator is deducted from the liquidation value of the assets). If the continuity of the activity is taken into account after the end of the explicit forecast period, the methods used to determine the terminal value that can be applied are included in the logic of the three approaches known: the cost, market or income approach. In this last case, one of the most frequently used formula is Gordon growth model (Iroval, 2015), the terminal value of the company ( $V_{ter}$ ) being calculated by means of the formula:

$$V_{ter} = \frac{CFN_{n+1}}{CMPC - g} \quad (5)$$

Where  $CFN_{n+1}$ =the net cash flow calculated for the first year of the non-explicit forecast period (for example, in the case of the company for which the turnover was previously assessed,  $CFN_{n+1}$  corresponds to 2021);

CMPC= Weighted average cost of capital or the discount rate;

g= expected long-term perpetual growth rate of CFN (the upper limit is given by the forecasts on the long-term GDP growth of the country in which the valuated company operates, and the inflation rate is added when CFN is forecasted in nominal terms)

For example, while in the case of the aforementioned entity, the net cash flow forecasted for the year after the explicit forecast period (2021) would be 21,200,000 lei, if the discount rate is 9 % and the annual expected growth rate of the net cash flow is 2%, then the terminal value of the company at the end of the explicit forecast period would be 302,857,142 lei [following the calculation:  $21,200,000/(9\%-2\%)$ ].

The problem of determining the adequate discount rate is complex and represents, essentially, “the rate of return expected by the capital investor in a competitive environment” or if the company is financed through several forms of capital (own, borrowed and preferential) the discount rate “expresses the profitability requirements of the company’s financiers” (Stan S. and Anghel I., 2016). The Guide on Valuation 1 “Discounted Cash Flow”, mentions that, in the case of the company valuation, forecasted cash flows are normally discounted using either the weighted average cost of capital (WACC), or the cost of equity.

For example, in conditions aforementioned, the company value is determined like in following tables (cash flows that are forecasted by the valuator separately for each year in the time period referred to as explicit are assumptions).

**Table no. 3 Determining the discounted factor**

Name/year	2016	2017	2018	2019	2020
Discount rate (k)	9%	9%	9%	9%	9%
Discounted factor= $\frac{1}{(1+k)^i}$	1:1.09 =0.917431	1:1.1881 =0.841679	1:1.295029 =0.772183	1:1.411581 =0.708425	1:1.538623 =0.649931

Source: authors’ own work

**Table no. 4 Determining the company value (lei)**

<b>Name/year</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>
Estimated cash-flow (CFN <sub>i</sub> ) -assumptions-	7,167,071	8,073,706	15,822,850	18,246,911	19,995,035
Discounted factor	0.917431	0.841679	0.772183	0.708425	0.649931
Discounted cash-flow $=CFN_i \times \frac{1}{(1+k)^i}$	6,575,293 (7,167,071×0.917431)	6,795,468	12,218,135	12,926,567	12,995,393
Discounted residual value=Residual value×0.649931 Discounted factor 2020 year					196,836,245 (302,857,142×0.649931)
Company value	6,575,293+6,795,468+12,218,135+12,926,567+12,995,393+196,836,245 = <b>248,347,101 lei</b>				

Source: authors' own work

## 6. CONCLUSIONS

The valuation method constituting the study object of this article is one of the most frequently used methods in the company valuation practice because it starts from the view of the investors in the market who are more interested in the ability of the company to generate cash flows, rather than in the value of its assets, many of these assets being subjected to a normal consumption or depreciation process.

The method is accepted by a large category of users, despite the fact that it is difficult to understand by those who do not have robust financial and quantitative forecasting knowledge. The disadvantages of the application of this method are also related to the high number of forecasts and their complexity and most forecast models imply the existence of a stability of the future evolution of the forecasted indicators. But for quite some time now, the world, European and implicitly national economy have been unstable and less predictable, crossing however periods of relative stability.

In addition to all these, another problem that is frequently faced by valuers is the lack of market data or insufficient information supplied by managers, based on which the forecast should be carried out. Despite of the fact that it poses so many difficulties in its application, the DFC method is, however, strongly supported by the users of information on company value and can be successfully applied by specialised valuers, with a good professional judgement, because it requires robust knowledge in various interconnected fields (valuation, accounting, statistics, econometrics, marketing, etc.).

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