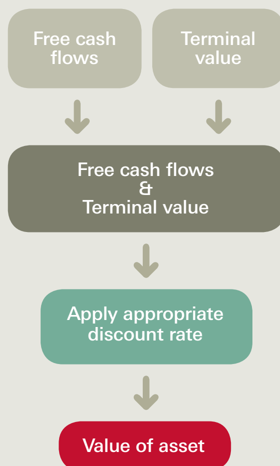
Global Economic Downturn fact sheet

Discounted Cash Flow Analysis

Series 1 – Issue 3

As part of the Institute's ongoing efforts to provide members with guidance and information on key issues affecting the current business environment, the Institute have developed a practical factsheet series, which presents guidance for members written by members.

Steps in a DCF analysis



Foreign exchange exposures

Foreign exchange rates are a highly sensitive variable which can affect both businesses with and without direct transactions in foreign denominated currencies.

The recent volatility and the depreciation of the Australian dollar must be considered in relation to the purchasing power and margins of any business. Analysis should be performed to understand the impact of foreign exchange fluctuations on future sustainable earnings and extending this to consider the impact on competitors, suppliers and customers.

The significance of foreign exchange rate movements is highlighted by the 32 per cent depreciation in AUD to USD since July 2008, as shown in the graph to the right.

Discounted Cash Flow Analysis

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Changes to Discounted Cash Flow (DCF) assumptions and calculations can significantly impact the carrying value of assets and liabilities and effect future decision making.

DCF analysis is a commonly used and the most technically sound technique for valuation. Having said this, the calculation itself is highly sensitive to the variables adopted.

Due to these sensitivities and the current economic climate, it is imperative to review DCF calculations, as changes to assumptions can significantly impact the carrying value of assets and liabilities and effect future decision making.

The main steps in a DCF analysis are summarised in the diagram to the left.

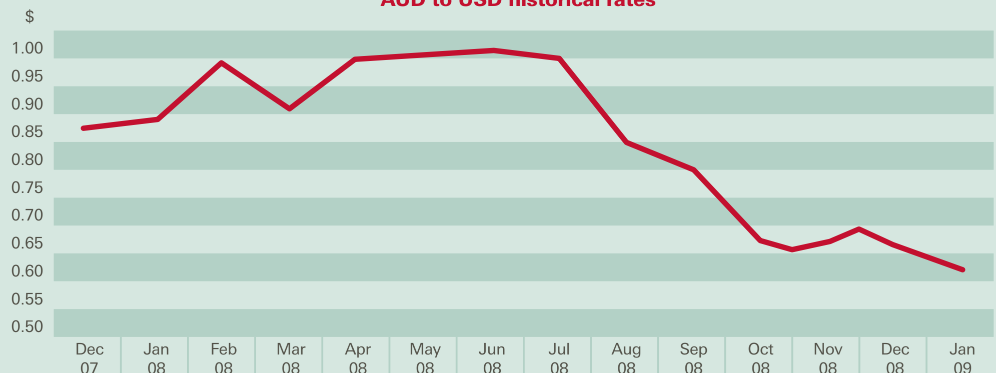
Further guidance on DCF is contained in the International Federation of Accountants' (IFAC) International Good Practice Guidance (IGPG), Project Appraisal Using Discounted Cash Flow.

The key impacts in DCF analysis in the current economic climate are:

Understand the business and its position in the market

Underpinning any DCF analysis is a sound understanding of the business or project being valued, including organisational strategy and the impact of the current competitive and economic climate on cash flows and risk factors. All variables adopted in a DCF calculation, should be reasoned, documented and regularly reviewed and updated where necessary.

DCF analysis should be interpreted in relation to an organisations business strategy. That is, the calculated present value of discounted cash flows should not solely influence the investment decision. In the current climate it is important to consider how accepting or rejecting the project would impact the organisations competitive advantage, its available capital for further investment or improve its position in the market, and what other potential alternatives may become available or restricted?



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Discount Rates – Impact of Current Climate

In determining an appropriate discount rate to apply, it is imperative to consider the components of the project or the organisation's funding structure, being the cost of debt, the cost of equity and their relative weightings.

The rate used should be that offered by comparable investment alternatives. Relevant factors to consider in the current climate include:

> Sustainability of existing funding structure
> Risk free rates are currently falling
> Risk of project failure for many ventures (beta) is currently increasing to reflect the uncertain economic future (macro & micro).
> Cost of business debt is increasing and is becoming increasingly difficult to obtain

Beta and calculation of discount rates will be addressed in a upcoming fact sheet in this series.

Sustainability of cash flows

Understanding the sustainability and sensitivity of forecast cash flows is essential in assessing both the level of forecast cash flows and associated risks in order to form a view on the appropriate discount rate.

There are several key factors to consider with regards to forecast cash flows:

- Sustainability of revenues: review of revenues with regards to the financial health and diversity of customer base
- Sensitivity of cash flows and key variables: which can identify key variables and help to identify worst, likely and best case scenarios
- Sensitivity of terminal value depends on which of the two main methods for calculation are used:
  - Perpetual growth formula: the terminal value is highly sensitive to the annual growth rate adopted, which should be carefully considered as to whether this is realistic.
  - Capitalisation of maintainable earnings method: the terminal value is highly sensitive to forecast maintainable earnings and the capitalisation multiple adopted. Both should be considered, particularly whether the risk of achieving the forecast earnings is adequately factored into the quantum of the multiple.

Overall, the timing and quantum of forecast cash flows should be regularly reviewed and updated where necessary.

Working capital position

Working capital is a simple but often misunderstood metric in determining the operating liquidity available to a business and is critical in assessing financial strength in any market climate. Small changes to working capital can have significant impacts on forecast cash flows.

In the current climate, increasing levels of working capital could signal issues with customers, suppliers and business practices. Common examples include:

- Debtors days increasing: which could be an indication that customers are having difficulty paying and may mean certain revenues are not sustainable going forward (notwithstanding the immediate negative impact to cash flow!)
- Suppliers renegotiating/reducing trading terms: this will directly impact immediate and forecast cash flows by bringing supplier payments forward and could be an indication that suppliers are experiencing underlying financial difficulties themselves
- Inventory build-up: could be an indication that the business is holding obsolete stock and that some stock is either un-sellable or would need to be discounted to sell or that the stock is being out-priced in the market or there maybe more attractive alternatives.

Conclusion

Overall, the current economic climate carries with it numerous factors which can significantly impact the DCF calculation.

For more information, guidance and tools on the global economic downturn refer to **charteredaccountants.com.au/news_issues/global_economic_downturn**

About the author

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