

## SS12: Foreshadowing

- **“Free Cash Flow...”**: Overwhelmingly important; extends DDM reading; lots of formulas
- **“Market-Based Valuation...”**: Intense analysis of DCF models applied to relative valuation (P/E, P/B, etc); LOTS of formulas
- **“Residual Income Valuation”**: Long reading; theoretically fabulous – hard to apply in practice; several new models and concepts

1218

## Free Cash Flow Valuation

LOS 42.a, SN Bk 4 p.197, CFAI Vol. 4 p.353

Equity Investments

## Introduction to Free Cash Flows

- Dividends are the cash flows **actually paid** to stockholders
- Free cash flows are the cash flows **available** for distribution after fulfilling all obligations (operating expenses and taxes) and without impacting on the future growth plans of the company (working capital and fixed capital)
- Extends the DCF approach with a more economically sound basis for the valuation than dividends

1220

LOS 42.a, SN Bk 4 p.197, CFAI Vol. 4 p.353

Equity Investments

## FCF Defined

- **FCFF** (Free Cash Flow to the Firm)
  - Cash available to shareholders and bondholders after taxes, capital investment, and WC investment, *pre-levered cash flow*
- **FCFE** (Free Cash Flow to Equity)
  - Cash available to equity holders after payments to and inflows from bondholders, *post-leverage cash flow*
  - Not equal to dividends actually paid

1221