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THE DELOREAN DASHBOARD: PREDICTING THE FUTURE TO DETERMINE CURRENT VALUE

presented by

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How Valuators Assess Forecasts & Translate Them into Value

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The Core Premise:

Value is Exclusively Forward-Looking

ACCOUNTING VS. VALUATION

Historical Results Inform the Future

Financial statements provide evidence of past performance. However, value is ultimately driven by a company's expected future cash flows, not its historical results.

THE FOUNDATION OF VALUE

Present Value of Future Cash Flows

The value of a business reflects the present value of the future economic benefits expected to be generated for investors.

THE VALUATOR'S ROLE

Evaluate Future Expectations

A valuator must assess whether management's assumptions regarding growth, profitability, and risk are reasonable and supportable.

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Preparing Forecasts

Top-Down & Bottom-Up Approaches

TOP-DOWN FORECASTING METHODOLOGY

- **Market Opportunity:** Assess the overall size and growth potential of the markets served by the company.
- **Market Position:** Evaluate whether projected growth is consistent with the company's competitive advantages and expected market share.
- **Pricing & Inflation:** Consider expected price increases, inflation impacts, and company's ability to pass costs through to customers.

BOTTOM-UP OPERATIONAL MECHANICS

- **Capacity & Sales Pipeline:** Evaluate whether staffing levels, production capacity, and sales opportunities can support projected growth.
- **Customer Economics:** Analyze customer acquisition trends, customer retention, contract renewals, and expected revenue per customer.
- **Existing Business Viability:** Consider backlog, recurring revenue streams, and existing contractual commitments that support future expectations.

***FORECAST HORIZON:* Standard explicit forecast window runs 3 to 10 years until the enterprise reaches "Economic Steady-State" (stable margins and normalized capital reinvestment).**

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Testing Forecast Feasibility

Growth vs. Return on Capital

1

Growth Must Create Value

Growth alone does not increase value. Net investments should generate returns that exceed the company's cost of capital.

2

Competition Erodes Excess Returns

Exceptional profitability is difficult to sustain indefinitely. Competitive forces often reduce returns overtime, particularly in mature industries.

3

Cash Flow Drives Value

Changes in accounting presentation or financial structure do not create value unless they improve long-term cash flow generation.

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Forecast Red Flags

When Additional Scrutiny is Warranted

- Growth significantly exceeds historical performance
- Margin expansion without operational support
- Growth without Reinvestment
- Forecasts outpace industry trends
- Assumptions inconsistent with economic reality

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The Discounted Cashflow (DCF) Framework

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DCF Framework

Converting Forecasts Into Value

1

Develop the Forecast

Project revenue, margins, taxes, reinvestment needs based on the company's expected future performance.

2

Estimate Future Cash Flows

Convert projected earnings into free cash flow available to investors after operating needs and required capital investments.

3

Measure Risk

Apply a discount rate that reflects the risk of achieving the projected cash flows and the time value of money.

4

Calculate Value

Sum the present value of forecast-period cash flows and the terminal value to estimate the total value of the business.

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DCF Framework

Converting Earnings Into Cashflow

EBIT → **NOPAT** → **+ D&A** → **- CapEx** → **- WC** → **FCF**

Operating Earnings
Starting operating income prior to debt or tax consideration

After-Tax Operating Earnings
Adjust operating income for taxes to estimate the earnings available to all capital providers

Non-Cash Charges
Add back depreciation, amortization, and other noncash charges

Capital Reinvestment
Deduct capital expenditures required for future growth

Operating Cash Needs
Deduct investment in working capital as growth requires investment in receivables and inventory, partially offset by trade payables and accrued liabilities

Operating Earnings
Cash flow available to all providers of capital before debt service and financing decisions

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Discount Rate Fundamentals

The Time Value of Money	A dollar received today is worth more than a dollar received in the future because investors can deploy capital elsewhere and earn a return.
Compensation of Risk	The discount rate reflects the uncertainty associated with achieving projected cash flows. Greater risk requires a higher expected return.
Risk and Value Move in Opposite Directions	Higher risk cash flows receive a higher discount rate, resulting in a lower present value. Lower risk cash flows receive a lower discount rate, resulting in a higher present value.
Matching Risk to Cash Flows	The discount rate should reflect the specific risks associated with the forecast, including industry conditions, company performance, customer concentration, and other factors impacting cash flow generation.

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Terminal Value

Estimating Value Beyond the Forecast Period

Captures Value Beyond Forecast Period

The forecast period represents only a portion of a company's life. Terminal value estimates the value of all cash flows expected after the explicit forecast horizon.

Reflects a Sustainable Operating Profile

By the terminal period, growth, profitability, and investment assumptions should reflect stable, long-term expectations rather than short-term advantages or disruptions.

Highly Sensitive to Key Assumptions

Small changes in terminal growths, profitability expectations, or discount rates can have a significant impact on the overall valuation conclusion.

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DCF Example

Free Cash Flow

Line Item ($M)	Year 1	Year 2	Year 3
Operating Income (EBIT)	$100.0	$115.0	$130.0
(-) Taxes on EBIT (@ 25%)	($25.0)	($28.8)	($32.5)
(+) Depreciation & Amortization	$15.0	$18.0	$20.0
(-) Capital Expenditures (CapEx)	($20.0)	($22.0)	($25.0)
(-) Δ Net Working Capital (NWC)	**($5.0)**	**($6.0)**	**($7.0)**
= FCF	**$65.0**	**$76.2**	**$85.5**

Free Cash Flow Takeaway

- FCF = EBIT(1-t) + D&A - CapEx - ΔNWC
- Capital Structure Neutral: Available to all debt & equity providers
- FCF Year 1: $65.0M
- FCF Year 2: $76.2M
- FCF Year 3: $85.5M

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WACC

Weighted Average Cost of Capital

WACC = [(E / TC) × Ke] + [(D / TC) × Kd × (1 – t)]

Cost of Equity (Ke)

- Formula: Ke = Rf + (Beta × ERP)
- Rf (Risk-Free Rate): 20-Yr Treasury
- Beta (Levered Systematic Risk)
- ERP (Equity Risk Premium): 5.0%

Cost of Debt (Kd)

- Yield to Maturity on company debt
- Tax Shield: Interest is tax-deductible
- After-Tax Cost = Kd × (1 – Tax Rate)
- Reflects lender risk premium

Capital Weights (E/TC & D/TC)

- Target Market Weights
- E/TC = Equity / Total Capital
- D/TC = Debt / Total Capital
- Ensure consistent capital structure

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Complete DCF Calculation

DCF STEPS & FORMULA

- Discount FCF at WACC (e.g., 9.0%)
- Terminal Value (Gordon Growth):
  TV = FCF [n+1] / (WACC–g)
- Discount TV to Present Value
- Enterprise Value = PV(FCF) + PV(TV)
- Equity Value = Enterprise Value + Cash – Debt

VALUATION SUMMARY BRIDGE ($M)

- PV of 5-Yr Explicit Cash Flows: $325.0M
- Terminal Value (at g = 2.5%): $1,150.0M
- PV of Terminal Value: $747.0M
- **Enterprise Value (EV): $1,072.0M**
- (–) Total Debt: ($200.0M)
- (+) Cash & Equivalents: $50.0M
- **Implied Equity Value: $922.0M**

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Scenario Analysis & Sensitivity Testing

Base Case

Most-Likely Outcome

Represents management's expected operating performance based on reasonable assumptions regarding growth, profitability, and reinvestment requirements.

Upside Case

Better-than-Expected Performance

Evaluates the impact of higher growth, stronger margins, faster market adoption, or other favorable operating outcomes.

Downside Case

Stress-Tested Performance

Evaluates the impact of slower growth, margin compression, economic weakness, competitive pressures, and other adverse developments.

Sensitivity Analysis: DCF conclusions should be tested against changes in key assumptions including growth rates, profit margins, and discount rates. Small changes in key assumptions can materially affect value, making sensitivity analysis an essential part of a DCF model.

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Grounding Forecasts

In Macro & Industry Reality

ECONOMIC CONSTRAINTS

- **Long-Term Growth Expectations:** Mature companies generally cannot grow faster than the overall economy indefinitely. Long-term growth assumptions should reflect realistic economic conditions.
- **Size Matters:** A company growing substantially faster than the economy year after year eventually reaches a scale that becomes difficult to sustain.
- **Inflation Considerations:** As businesses mature, a larger portion of growth often comes from price increases rather than continued gains in volume or market share.

INDUSTRY CONSTRAINTS

- **Market Opportunity Limits:** Revenue growth should be evaluated relative to the size and growth of the markets the company serves.
- **Competition Increases Over Time:** Strong growth and high profitability often attract new competitors, alternative products, and pricing pressure.
- **Industry Headwinds:** Regulation, customer preferences, technological change, labor availability, and economic cycles can all limit long-term growth and profitability.

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Forecast Analysis in Practice

Application	Role of Forecasts
ESOP Valuation	Often a primary input to the valuation
Fair Value/409A	Frequently incorporated into DCF and allocation analyses
Commercial Litigation	May be challenged, adjusted, or disregarded depending on reliability and timing of preparation
M&A/Strategic Planning	Often central to assessing transaction value and investment returns

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Five Golden Rules

For Defensible DCF Valuations

1. Value is based on cash flow, not earnings: Strong accounting profits do not necessarily translate into value. Focus on the cash flow available to investors.
2. Forecasts must be economically achievable. Growth assumptions should be consistent with economic conditions, industry dynamics, and the company's competitive position.
3. Growth requires reinvestment. Revenue growth often requires additional investment in working capital, personnel, equipment, technology, and other operating assets.
4. Test assumptions, don't accept them. Evaluate management's projections using historical performance, market evidence, economic data, and scenario analysis.
5. Small assumptions can have large impacts. Changes in growth rates, margins, discount rates, and terminal value assumptions can materially affect the valuation conclusion.

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Summary

Key Take-Aways

- **Forecasts Drive Value:** A DCF is a reflection of expected future cash flows. The quality of the valuation depends on the quality of the forecast.
- **Assumptions Must Be Supportable:** Growth, profitability, and reinvestment assumptions should be grounded in economic realities, industry dynamics, and company-specific factors.
- **Judgment Matters More than the Math:** Building a DCF model is straightforward. Evaluating whether the assumptions are reasonable is where valuators create value.

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Thank You!
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