Twitter Thread by Dinesh Sairam

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1/ I've Valued 150+ companies using the Discounted Cashflow (DCF) Model. Far be it for me to say I am an expert. But if you've done this as much as I have, you start noticing certain patterns.

Here are 10 lessons I've learned from using the Discounted Cashflow Model.

2/ Every investment decision you make follows a Discounted Cashflow calculation.

You let go of X today to earn Y in the future. You wouldn't do that if you didn't expect to earn an expected amount of returns (r).

Nobody wants to let go of X and get back X years down the line.

3/ When you invest in a company, you hold claim over the Assets and the Profits of a Company. Without diluting your ownership, Assets and future Profits are generated out of one thing and one thing alone: Free Cash Flow to Firm.

FCFF is the treasure at the end of the rainbow!

4/ Combining the above two observations, a company may not always make Profits in the present. In fact, if it's a young company or in a new market, losses are a given.

Eventually though, future profits should be large enough to offset or overtake all the past losses in PV terms.

5/ For most companies, generating Returns falls in a spectrum: Have high Margins and generate lower Sales in relation to Capital Employed Vs. Turn Assets faster but have low Margins (Or somewhere in between).

For Indian context, compare the Business Models of D-Mart Vs. NESCO.

6/ Value is accrued to you as an owner/shareholder only if the company's Cash Returns are greater than what you expected to earn from the investment.

The 'technical' definition is the spread between RoCE and Cost of Capital. But the former is simpler and much more intuitive.

7/ Not all Growth is good.

Say, you expect a company to earn 15% Returns. The company enters a 50% Growth market. After deducting the expenses and investments, the net Returns are only 10%. 50% Growth sounds great, but this Growth destroys Value.

For context, see many Startups.

8/ Profitability is quite important. But equally important and generally overlooked is Sustainability.

There's a balance to be stricken, but more often than not, Sustainability of Profits over decades is much more preferable to High and unsustainable Profits.

9/ Cash has Real Option Value.

Cash held today by a company can either be rotting in irrelevant investments/FDs or it can go on to fund a lucrative investment or market entry for the firm. Otherwise, they can also be paid out as Dividends.

See: https://t.co/LsF351Jwg4

10/ A 'Moat' or Sustainable Competitive Advantage can come from a variety of factors. But largely, it results in an optimization of one or more of the Value factors of Margins, Asset Turns, Growth or Risk.

Below are just a few examples of possible Moats.

11/ Sometimes, less is more.

I tend to do both ways of accounting for Risk. I do the first and tedious way often when I Value a company for the first time. For most future Re-Valuations, I stick to a fixed level of Margin of Safety.

12/ Ultimately, Value to you as an owner or shareholder is based on three components: Numbers, Stories and Conviction.

You can build the best DCF Model in the world, but if any one of these inputs is lacking, the output will be sub-optimal. Get all of them right.

13/ I'm surprised by the attention this thread has received. So, here are 3 more lessons I learned from using a DCF.

Leverage helps, but leverage also kills.

14/ In order to account for Risk, you can either be more conservative in assumptions or use a higher discounting rate (Assuming you understand the business, of course).

Both of these processes lead to the same outcome of a decreased expected purchase price.

15/ Different businesses behave differently based on where they are in the Business Lifecycle.

Another lesson to be gleaned from this is that every business will eventually decline. Even Jeff Bezos admits that Amazon will fail one day and the aim is to prolong that event.