

## VALUATION

### Discounted Cash Flow Methodology – Dividend Discount Model

**The Dividend Discount Model (DDM) is a methodology to value a stock by using expected dividends and discounting them back to present value.**

The DDM is a valuation technique especially suitable for dividend stocks: These are shares of companies which pay out a substantial amount or all of the firm's net income in the form of cash dividends to shareholders. The DDM can be considered as a special form of the DCF valuation approach, whereby in most cases the Gordon Growth Model is applied.

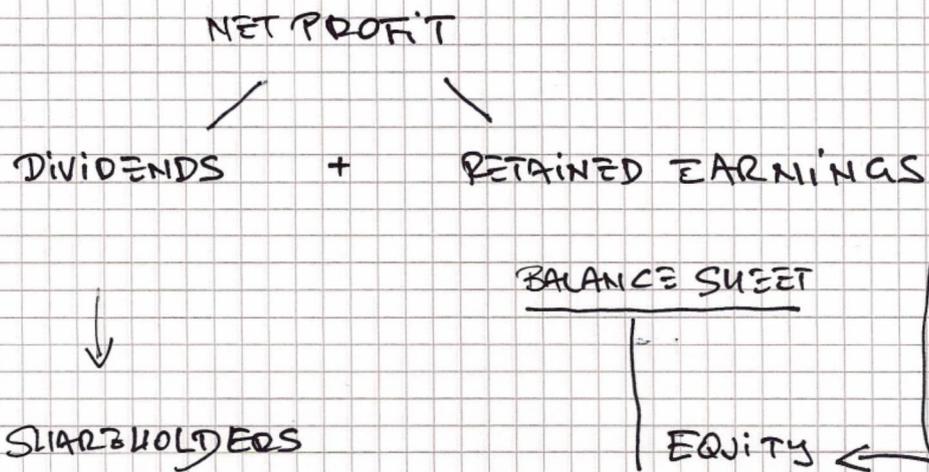
The DDM values all future dividends, in essence representing the future cash flows to a share: Accordingly, the value of the stock equals the sum of the net present values of all future dividends. Thereby, the cost of equity is used as a discount factor, as dividends are in full commercial and economic ownership of shareholders only.

In applying the Gordon Growth Model, it is assumed that future expected dividends will grow every year with a fixed, determined rate.

The problem with the DDM is that it basically ignores earnings which are retained in a firm (and not being paid out in the form of dividends). Such retained earnings are, however, absolutely essential to maintain the growth momentum of a company.

Further, the Gordon Growth Model seems also flawed in assuming a constant growth rate of future expected dividends: This may be acceptable for a minority stake in a fairly high-yielding mature company. However, for stocks with lower dividend yields or such with a strong momentum of anticipated dividend growth, this approach seems not appropriate.

Finally, the DDM approach is highly sensitive to the accuracy of inputs: For example, dividend growth rates of mature companies can at times be fairly high, maybe even higher than the core company's net income growth (possibly due to share buybacks). - It is evident, however, that such a momentum cannot go on for a long time, especially as when a firm has already reached a later stage of maturity with earnings and dividend momentum probably about to stall within a foreseeable period of time.



### DDM - GORDON GROWTH MODEL

