Discounted Cash Flow Methodology – Dividend Discount Model

The *Dividend Discount Model (DDM)* is a methodology to value a stock by discounting future expected dividends and estimate their present value.

The DDM is a valuation technique with a focus on dividend stocks: These are stocks of firms which distribute a substantial amount or all of their net income in the form of cash dividends to shareholders. Therefore, the DDM is a special form of the DCF valuation approach, whereby in most cases the Gordon Growth Model is applied.

The DDM values all future expected dividends, in essence representing future cash flows leaving the firm and paid directly into a shareholder´s account: Hence, the value of the stock equals the sum of the net present values of all future cash dividends paid. Thereby, the cost of equity is used as a discount factor, as dividends are in full economic ownership of shareholders only.

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

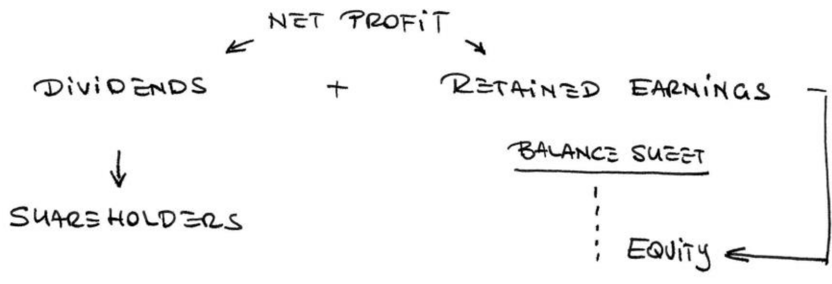
In the past, cash dividends were considered as the principle indicator of a company´s financial health, long before laws required firms to disclose financial information. However, applying a dividend-based valuation model, such as the DDM, in today´s environment, is amid much improved access to information, problematic: To start with, a firm´s periodic retained earnings (the portion not being paid out as cash dividends) are entirely ignored, whilst the economic ownership of this position is in the hands of shareholders, perhaps representing a major component of their vested value in a firm.

Having said this, allocating net income to retained earnings may admittedly play a lesser role for mature companies: Having already reached later stages in their respective life cycles, accumulating additional retained earnings may not be required any longer, instead rather contribute to an inefficient capital structure. Hence, the preferred choice is dividends (fully) paid to shareholders (dividend stocks).

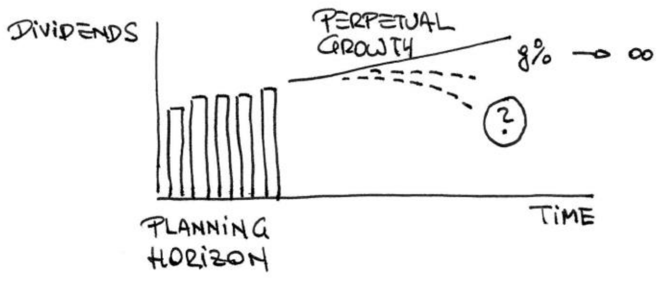
However, the assumption made in the Gordon Growth Model of a constant growth rate of future expected dividends is indeed daring: Whilst such may be acceptable medium-term when assessing a minority stake in a high-yielding mature company, on the long run this assumption seems unrealistic.

Instead, companies entering the life cycle stages of maturity or decline may radically amend their respective dividend policy: In some cases, the dividend payout ratio may be substantially increased, perhaps even exceeding net income. - This will not be sustainable, though. Besides, neither could a firm´s dividend growth rate outpace net income growth long-term.

In another scenario, a firm in the later stages of its respective product life cycles may decide to reinvent itself: In this specific case, no dividends may be paid out at all in the foreseeable future, as management aims to preserve cash and invest that in newly created or future businesses.



DDM - GORDON GROWTH MODEL



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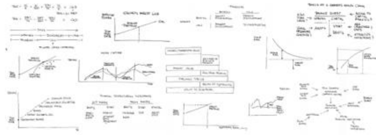

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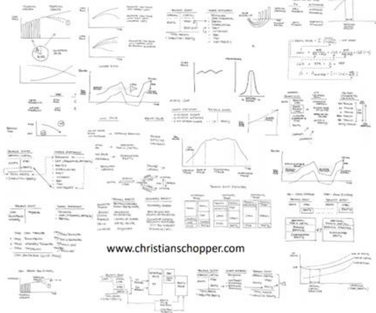

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