Discounted Cash Flow Methodology – Dividend Discount Model

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

The DDM is a valuation technique with a focus on dividend stocks: These distribute a substantial amount or all of a firm´s 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 annually grow 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, today, is amid much improved access to information, problematic:

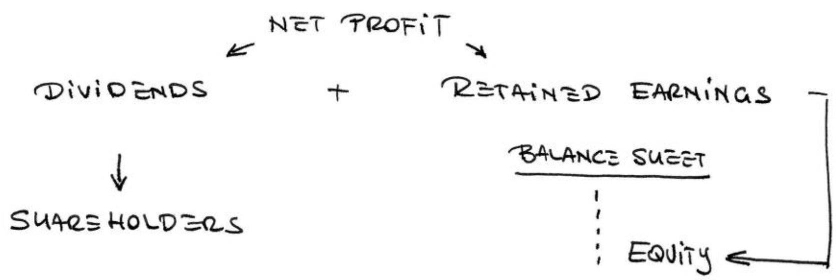
To start with, a firm´s periodic retained earnings (the portion not being paid out as cash dividends) are entirely ignored, whilst in the economic ownership of shareholders, perhaps representing a major component of their vested value in a firm.

Having said this, annual retained earnings may admittedly play a lesser role in regards to mature companies: Having reached already a later stage in their respective life cycles, accumulating further retained earnings may not be required any longer with dividends therefore be (fully) paid to shareholders (dividend stocks).

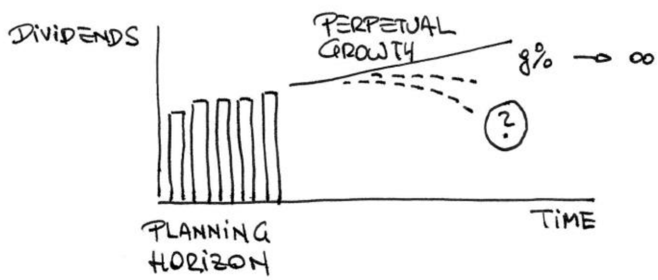
However, the assumption in the Gordon Growth Model of a constant growth rate of future expected dividends is indeed daring: Whilst such may be acceptable medium-term for a minority stake in a high-yielding mature company, on the long run this assumption will in all likelihood be unrealistic.

Instead, companies entering the maturity or decline phases in their respective life cycles 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. Neither could long-term the dividend growth rate outpace a company´s net income growth.

In another scenario, a firm may decide to reinvent itself: In that 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 and future businesses.



DDM - GORDON GROWTH MODEL



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