



Investment Value Analysis of Internet Companies Based on the FCFF Model

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ABSTRACT

With the continuous progress and development of society, China's capital market has experienced successive waves of investment enthusiasm. As investors' perspectives become increasingly rational, companies' management objectives have shifted from an initial focus on profit maximization to a broader goal of maximizing corporate value. Throughout this evolution in management goals, investors have become more concerned with the intrinsic value of companies. With the advent of the 5G era, the internet industry is experiencing a new wave of development. Against this backdrop, how investors can reasonably assess the value of internet companies and capture their intrinsic investment value has become critically important. This paper evaluates the corporate value of Internet Company A based on the Free Cash Flow to Firm (FCFF) model, exploring the model's applicability in the internet industry and providing a reference for investors seeking to assess corporate value.

Keywords: Investment Value, Valuation, FCFF Model, Internet Companies.

INTRODUCTION

With the rapid rise of China's digital economy, internet companies, as a key component of this sector, have increasingly demonstrated their pivotal role in daily life. Building on this foundation, the internet gaming industry has seen substantial growth and expanded its influence. In recent years, the booming online gaming industry in China has attracted numerous internet companies, fueling capital inflows into the gaming sector. Over the past decade, many internet companies have engaged in cross-sector acquisitions and investments within the gaming industry, making initial public offerings (IPOs), financing, and mergers and acquisitions (M&A) the mainstream avenues for growth. Notable acquisitions, such as Riot Games and Microsoft's acquisition of Activision Blizzard, have captured the industry's attention. The frequent M&A activities in the gaming market have led to an increasing demand for the valuation of internet gaming companies. Therefore, both capital investors looking to invest in online gaming companies and gaming companies seeking external capital to drive their progress have a growing interest in properly estimating the value of these companies. This paper focuses on the internet industry, specifically exploring the applicability of the FCFF valuation method in this domain. By taking Internet Gaming Company A as a sample, we conduct a corporate valuation, providing valuable insights for investors conducting practical research.

Relevant Concepts and Valuation Methods

Concept of Corporate Investment Value:

Corporate value is an important indicator for measuring a company's overall strength and its potential for future development. It refers to the value derived from the current and future economic indicators of a company. Corporate valuation involves both quantitative and qualitative analyses of a company's overall value. By employing specific valuation methods and techniques, relevant business indicators are gathered, classified, and analyzed to quantify a company's assets, profitability, and future growth potential, ultimately arriving at an overall valuation for the company at present and over a certain future period.

Research on corporate valuation began earlier in the international academic community, where the theoretical framework is relatively well-developed. Scholars have primarily focused on studying corporate valuation through various methods, including discounted cash flow (DCF), real options, and relative valuation techniques. Sun Zhijia and Pan Qingquan (2024) pointed out that the Free Cash Flow to Firm (FCFF) model is particularly suitable for valuing companies in good operating conditions and exhibiting continuous growth. Wang Fanglin et al. (2024) applied the FCFF model to value publicly listed companies, validating the reasonableness of corporate valuation using this method. Gong Lingyu and Ye Zhifeng (2024) conducted an empirical study analyzing the applicability of the DCF model for corporate valuation, highlighting that this model is well-suited for companies with stable and predictable cash flows. Wu Xiaochang (2024) compared different valuation methods and concluded that the relative valuation method yields more accurate results when valuing innovative small and medium-sized enterprises (SMEs). Li Hang and Li Qian (2024) employed the DCF method to assess the value of new energy companies. Xiao Yueyao and Li Chaohong (2024) combined the DCF method (FCFF) with the option pricing model (B-S) to conduct a comprehensive valuation of coal companies. Li Quanshun and Zong Kaixuan (2024) used the DCF method to evaluate the value of new energy vehicle companies, taking Company B as a case study.

Free Cash Flow Theory:

The Free Cash Flow (FCF) theory was first introduced by British scholar Jensen (1986) and is also known as the agency cost theory of free cash flow. This theory suggests that the structure of corporate financing can constrain free cash flow, reducing the amount of cash available to managers for crisis management. By limiting managerial control, this can have a positive impact on addressing agency problems within the company and can ultimately influence the company's value. The ability of a company to freely distribute cash to shareholders and creditors is crucial for maximizing value creation.

Based on the concept of free cash flow, this study discounts the annual free cash flows of Company A using an appropriate discount rate to calculate the net present value (NPV) of the cash flows for each year. This approach serves to estimate the overall value of Company A. The specific model is presented as follows:

$$V_1 = \sum \frac{FCFF_t}{(1 + WACC)^t} + \frac{FCFF_{n+1}}{(WACC - g)(1 + WACC)^n}$$

To explain the formula mentioned above: the variable VVV represents the value of the company, while FCFF stands for the future free cash flows of the firm. The term WACCWACCWACC refers to the Weighted Average Cost of Capital, and ggg denotes the stable growth rate. The formula for FCFF is given by:

$$WACC = R_e \frac{E}{D + E} + R_d * (1 - t) \frac{D}{D + E}$$

$$R_e = R_f + \beta * (R_m - R_f)$$

In terms of equity capital, the indicator EEE represents its magnitude, while ttt denotes the corporate income tax to be paid. DDD refers to the scale of the company's debt capital, ReReRe is the cost of equity capital, and RdRdRd corresponds to the cost of debt capital.

Applicability of the FCFF Model

Company A's core business generates relatively stable revenues, and its cash flow situation is generally favorable. The FCFF model can accurately capture Company A's operating cash flow and discount it to reflect the company's intrinsic value. This approach considers both the company's current operational performance and its long-term growth potential, offering a more comprehensive perspective for valuation. By using future cash flows as the basis for discounting returns, this method not only incorporates the company's current capabilities but also takes into account its future profitability and growth potential. In addition to internal factors, it also integrates external macroeconomic conditions, making the valuation process more objective and realistic. The FCFF model effectively reflects the risk characteristics of Company A by appropriately setting the discount rate to include these risk factors in the valuation, thus arriving at a fairer value estimate. Furthermore, the FCFF model can predict and analyze the future development trends of Company A. Based on forecasts of the company's future cash flows, the model provides insights into the intrinsic value and long-term investment value of Company A, offering strong support for investment decisions.

INVESTMENT VALUE ASSESSMENT OF COMPANY A BASED ON THE FCFF MODEL

Calculation of Company A's Value Using the FCFF Model

Calculation of Value During the Forecast Period:

Free Cash Flow Forecast:

(1) Operating Revenue:

As one of China's leading internet gaming companies, Company A's revenue growth has shown significant volatility over the past few years. However, with increasing industry competition and the growing demand to meet more discerning user needs, gaming companies must continuously improve product quality, which inevitably raises research and development (R&D) costs and intensifies market pressure. Additionally, the "Matthew effect" within the industry has become more pronounced. As market concentration increases, consumer attention and funds are gradually concentrated on a few popular games and leading companies, intensifying the competitive pressure on mid-sized and large gaming companies. Although Company A holds a leading position in the industry, its market share expansion is constrained by the fierce competition from giants like Tencent and NetEase. Moreover, the lifecycle of popular games has become increasingly short, requiring gaming companies to continually

release new hit games to maintain sustainable revenue, which imposes higher demands on Company A's R&D and operational capabilities.

Table 1: Company A's Operating Revenue from 2019 to 2023 (in billions)

Project	2019	2020	2021	2022	2023
Operating Revenue	132.27	144.00	162.16	164.06	165.47
Revenue growth rate	73.30%	8.86%	12.62%	1.17%	0.86%

Data Source: Company A's Annual Reports from 2019 to 2023

Based on the previous analysis, Company A is currently in a phase of slowed growth. After reviewing performance forecasts from various securities firms, this study assumes a growth rate of 3% for Company A in 2024. In recent years, Company A has faced increasing market competition, especially under the pressure from both domestic and international gaming industry giants. As a result, the company has struggled to maintain the high growth rates it enjoyed in the past. Additionally, as the domestic gaming market approaches saturation, the cost of acquiring new customers has risen, and the potential for user growth has become constrained, leading to a short-term slowdown in performance growth.

For 2025, a growth rate of 5% is assumed, and from 2026 to 2028, the growth rate is further projected to increase to 8%, based on the assumption that the company will successfully navigate competition and achieve sustainable growth over the medium to long term. During this period, Company A is expected to improve its market share and profitability by increasing R&D investments, expanding into international markets, and enhancing its intellectual property (IP) operations. The assumed 8% growth rate reflects the company's potential for renewed growth momentum in the coming years. Accordingly, Company A's projected revenues for 2024-2028 are presented in Table 2.

Table 2: Projected Revenue Analysis of Company A from 2024 to 2028 (in billions)

Project	2024	2025	2026	2027	2028
Operating Revenue	170.43	178.96	193.27	208.73	225.43
Operating Revenue Growth Rate	3%	5%	8%	8%	8%

(2) Operating Costs

According to data from Company A's reports for 2019-2023, the proportion of operating costs initially declined from 23.73% to 12.21%, and then increased to 18.58%, with an average proportion of 16.63%. This reflects Company A's strategic adjustments in cost control and resource allocation. The initial decline was attributed to optimized operational processes and improved efficiency. However, as market competition intensified, Company A needed to invest more funds in technological innovation and product development to maintain its competitive edge, leading to a subsequent rise in the proportion of operating costs.

Given the increasing pressures in the online gaming industry, Company A plans to scale up and continue increasing its R&D investments. By boosting investments, the company aims to make breakthroughs in technological innovation and new product development to attract more users and expand its market share. This also includes upgrading infrastructure and investing in talent to support sustained growth. In the face of industry pressures, a reasonable increase in costs is crucial for ensuring the company's long-term competitiveness. By strengthening R&D,

Company A can enhance product quality and user experience, thereby securing a favorable position in the competitive market. For this analysis, it is assumed that the average proportion of operating costs over the next five years will be 20%, resulting in the projections shown in Table 3.

Table 3: Projected Operating Costs of Company A from 2024 to 2028 (in billions)

Project	2024	2025	2026	2027	2028
Operating Revenue	170.43	178.96	193.27	208.73	225.43
Operating cost	34.09	35.79	38.65	41.75	45.09
Cost ratio	20%	20%	20%	20%	20%

(3) Pre-Tax Net Operating Profit

By analyzing the annual report data, it is observed that the proportions of management expenses, business taxes and surcharges, and sales expenses relative to operating revenue remained relatively stable from 2019 to 2023. Consequently, this study uses the average proportions as the basis for forecasting these expenses for the projection period. The average proportions are 0.26% for business taxes and surcharges, 55.99% for sales expenses, and 2.77% for management expenses. The stability of the business taxes and surcharges ratio over multiple years indicates that the company has good control over tax management. This stability aids the company in forecasting and planning future financial expenditures, ensuring that tax risks are manageable.

The high proportion of sales expenses is typical for the online gaming industry, reflecting the need for substantial investment in marketing and user acquisition to maintain competitiveness and user engagement. Company A's consistent expense ratio in this area over the past few years suggests that its marketing strategy and budget allocation are well-established, effectively supporting business growth and market expansion.

The management expenses ratio demonstrates the company's efficiency in internal management. The stability in management expenses reflects the company's capability in controlling operational costs and enhancing management efficiency, allowing more resources to be allocated to core business activities and innovation efforts.

Pre-tax net operating profit can be calculated by subtracting operating costs, taxes and surcharges, sales expenses, and management expenses from the forecasted operating revenue. The resulting projections for Company A's pre-tax net operating profit for 2024-2028 are shown in Table 4.

Table 4: Projected Pre-Tax Net Operating Profit of Company A from 2024 to 2028 (in billions)

Project	2024	2025	2026	2027	2028
Taxes and surcharges	0.44	0.46	0.50	0.54	0.58
Selling expense	95.43	100.21	108.22	116.88	126.23
Administrative expenses	4.72	4.96	5.36	5.79	6.25
Net operating profit before tax	35.75	37.54	40.54	43.77	47.28

(4) Post-Tax Net Operating Profit

Based on Company A's annual reports, the corporate income tax rate is 25%. Therefore, the forecasted post-tax net operating profit for Company A is presented in Table 5.

Table 5: Projected Post-Tax Net Operating Profit of Company A from 2024 to 2028 (in billions)

Project	2024	2025	2026	2027	2028
Net operating profit before tax	35.75	37.54	40.54	43.77	47.28
Corporate income tax expense	8.94	9.39	10.14	10.94	11.82
Net operating profit after tax	26.81	28.16	30.41	32.83	35.46

(5) Depreciation and Amortization

Depreciation and amortization refer to the allocation of the cost of long-term operating assets, excluding fixed assets, over their useful lives. The proportion of depreciation and amortization to operating revenue from 2019 to 2023 is calculated as follows: 0.84%, 0.81%, 1.23%, 1.30%, and 1.17%, respectively.

However, according to the annual report, Company A initiated the construction of its Guangzhou headquarters in 2020, with the project expected to be in use by December 31, 2024. Once this project is completed and operational, it is anticipated that the company's fixed asset depreciation and amortization expenses will increase. Therefore, a forecast proportion of 1.5% for depreciation and amortization is deemed appropriate and relatively stable for the projection period. The forecasted depreciation and amortization data for Company A is presented in Table 6.

Table 6: Projected Depreciation and Amortization of Company A from 2024 to 2028 (in billions)

Project	2024	2025	2026	2027	2028
Depreciation and amortization	2.56	2.68	2.90	3.13	3.38
Depreciation and amortization ratio	1.5%	1.5%	1.5%	1.5%	1.5%

(6) Capital Expenditures

Capital expenditures (CapEx) refer to the funds a company uses to acquire, upgrade, or maintain fixed assets, intangible assets, and other long-term assets. This typically includes investments in fixed assets (such as land, buildings, machinery, and equipment), intangible assets (such as patents, trademarks, copyrights, and software), and other long-term assets (such as long-term investments and R&D expenditures). By analyzing capital expenditures, a company can gauge its investment intensity in fixed and intangible assets, which in turn helps assess its future growth potential and competitive strength. Additionally, CapEx is a crucial indicator of a company's financial health, as excessively high capital expenditures can lead to cash flow constraints, while insufficient CapEx can affect long-term development.

Analysis of capital expenditures indicates that the proportion of CapEx has been relatively stable since 2021. Therefore, an average proportion of 0.73% for capital expenditures from 2021 to 2023 is used as the forecasted proportion for the projection period. The forecasted capital expenditures for Company A are presented in Table 7.

Table 7: Projected Capital Expenditures of Company A from 2024 to 2028 (in billions)

Project	2024	2025	2026	2027	2028
Capital expenditure	1.24	1.31	1.41	1.52	1.65
Capital expenditure as a percentage	0.73%	0.73%	0.73%	0.73%	0.73%

(7) Increase in Working Capital

Working capital refers to the funds a company allocates to its current assets, including accounts receivable, inventory, other receivables, notes payable, advance payments, accrued expenses, and other payables. Working capital reflects the amount of money a company needs to invest in its day-to-day operations and is the difference between current assets and current liabilities. It represents the company's short-term financial liquidity and operational efficiency. Effective management of working capital is crucial for maintaining smooth operations and gaining a competitive edge.

Changes in working capital can reveal fluctuations in a company's funding needs during operations. An increase in working capital indicates a greater need for funds to support operations, often due to business expansion or higher levels of inventory and receivables. Conversely, a decrease in working capital suggests improved efficiency in fund utilization or a reduction in operational scale. Based on the company's annual reports, and after excluding the extreme data from 2019, 2020, and 2021, the average proportion for the remaining years is 2.49%. This value is used as the forecasted proportion for the projection period. The forecasted increase in working capital for Company A is shown in Table 8.

Table 8: Projected Increase in Working Capital for Company A from 2024 to 2028 (in billions)

Project	2024 年	2025 年	2026 年	2027 年	2028 年
Increase in working capital	4.25	4.46	4.82	5.21	5.62
Increase in working capital as a percentage of operating income	2.49%	2.49%	2.49%	2.49%	2.49%

(8) Free Cash Flow

Based on the above calculation formula, the forecasted free cash flow for Company A for the period from 2024 to 2028 is shown in Table 9.

Table 9: Projected Free Cash Flow of Company A from 2024 to 2028 (in billions)

Project	2024	2025	2026	2027	2028
Net operating profit after tax	26.81	28.16	30.41	32.83	35.46
Depreciation and amortization	2.56	2.68	2.90	3.13	3.38
Capital expenditure	1.24	1.31	1.41	1.52	1.65
Increase in working capital	4.25	4.46	4.82	5.21	5.62
Free Cash Flow	23.88	25.07	27.08	29.23	31.57

Discount Rate Calculation:

Given that this valuation focuses on the overall enterprise value of Company A, and to ensure calculation accuracy, a uniform standard is used in the income approach. This paper decides to use the Weighted Average Cost of Capital (WACC) model to estimate the discount rate.

- (1) **Debt and Equity Capital Proportions:** By analyzing the annual report data, the proportions of debt and equity capital for Company A from 2019 to 2023 are calculated. It is observed that, except for 2020, where there were significant fluctuations in the proportions of debt and equity capital, the data for other years remained relatively stable. Therefore, the data for 2020 is excluded, and the average proportions for the remaining four years are calculated, resulting in a debt capital proportion of 28.48% and an equity capital proportion of 71.52%.
- (2) **Cost of Debt Capital:** Based on the annual report data, Company A's current liabilities have remained high and stable over the past five years. Hence, the one-year benchmark lending rate of 4.35% published by the People's Bank of China in 2023 is used as the cost of debt capital for Company A.
- (3) **Cost of Equity Capital:** The formula for calculating the cost of equity capital is as follows:

$$R_e = R_f + \beta * (R_m - R_f)$$

- Risk-Free Rate Determination: In the Capital Asset Pricing Model (CAPM), the yield on government bonds is generally used as the risk-free rate. This is because government bonds are backed by national credit and have a very low risk of default, making them a suitable proxy for the risk-free rate. According to information published by the Ministry of Finance, the yield on a ten-year government bond in December 2023 was 2.59%.
- Determination of Beta (β): The risk coefficient β for Company A has been obtained from the Guotai Junan database, with a β value of 1.63.
- Determination of Market Risk Premium (R_m): The market risk premium can be represented by the stock market's returns. Here, the CSI 300 Index, a major stock index, is used to approximate market returns. By calculating the returns of the CSI 300 Index over the past decade, the average return is found to be 8.83%.
- Cost of Equity Capital Calculation: Using the previously determined values for R_m and β , the cost of equity capital is calculated with the following formula:

$$R_e = R_f + \beta * (R_m - R_f)$$

$$R_e = 2.59\% + 1.63 * (8.83\% - 2.59\%) = 12.76\%$$

- (4) **Calculation of Discount Rate:** To calculate the discount rate, we substitute the values into the following formula:

$$WACC = R_e \frac{E}{D + E} + R_d * (1 - t) \frac{D}{D + E}$$

$$WACC = 12.76\% * 71.52\% + 4.35\% * 28.48\% * (1 - 25\%) = 10.05\%$$

Forecast Period Enterprise Value:

$$V_1 = \frac{23.88}{(1+10.05\%)} + \frac{25.07}{(1+10.05\%)^2} + \frac{27.08}{(1+10.05\%)^3} + \frac{29.23}{(1+10.05\%)^4} + \frac{31.57}{(1+10.05\%)^5} = 102.20 \text{ 亿元}$$

Calculation of Terminal Value:

Over the past 30 years, the global economic growth rate has stabilized around 3%, which is widely considered the average growth rate for economies in a mature development stage. As a mature internet entertainment company, Company A will experience short-term fluctuations due to market competition, industry cycles, and technological innovations. However, in the long

term, its growth rate is expected to align with the global economic growth rate. Additionally, as the industry gradually matures, the stabilization of market share and the saturation of the user base will cause the company's growth to level off. Therefore, this paper assumes a terminal growth rate of 3% for Company A.

$$V_2 = \frac{31.57 * (1+3\%)^5}{(10.05\% - 3\%)(1+10.05\%)^5} = 285.74 \text{ billion yuan}$$

Valuation Results:

Based on the calculations above, the projected enterprise value of Company A during the forecast period is 10.22 billion yuan, while the terminal value of Company A is 28.57 billion yuan, resulting in a total enterprise value of 38.79 billion yuan. As of December 31, 2023, Company A's total shares outstanding are 22,178.6 million, giving an intrinsic value per share of 17.49 yuan.

RESEARCH CONCLUSIONS AND INVESTMENT RECOMMENDATIONS

Research Conclusions

This study demonstrates the effectiveness and limitations of the FCFF model in valuing internet companies, as evidenced by its application in evaluating Company A. The FCFF model proves reliable for estimating intrinsic value, particularly in the dynamic and competitive environment of the internet industry. It not only accounts for a company's current operational state but also incorporates future cash flows and growth potential, offering a comprehensive view of the company's value.

The analysis revealed a discrepancy between the market price and the model's intrinsic value estimate. This variance reflects differing market expectations about the company's future performance and the influence of market sentiment and external economic factors. Therefore, while the FCFF model is a powerful tool for quantitative valuation, it should be used alongside market data and industry context for a more nuanced analysis.

Moreover, the importance of comparing model results with actual market data is emphasized. Such comparisons can reveal whether market valuations are reasonable and provide more accurate information for investment decisions. Future research could explore integrating multiple valuation methods to enhance precision in value predictions, addressing market fluctuations and industry trends.

Investment Recommendations

When evaluating company value, the FCFF model offers a structured approach by considering free cash flows, capital costs, and growth potential. However, relying solely on one model's results should be complemented with market data and macroeconomic factors for more reliable investment decisions.

Investors should consider the following recommendations when using the FCFF model:

- **Multi-Dimensional Analysis:** Combine multiple valuation methods and models, such as relative valuation and real options approaches, to obtain a more comprehensive view of a company's value. Different models can reveal various aspects of intrinsic value and market performance.

- **Market Dynamics Monitoring:** Stay updated on market trends, industry developments, and macroeconomic changes, as these factors can impact a company's operational status and future cash flow projections, affecting valuation accuracy.
- **Risk Assessment and Adjustment:** Incorporate risk factors, such as market competition, policy changes, and technological innovations, into the valuation process. Adjust discount rates and other parameters to reflect these risks, providing a more realistic valuation.
- **Long-Term Perspective:** For high-growth sectors like the internet industry, long-term development potential is crucial. Evaluate a company's innovation capabilities and market expansion strategies to assess future growth prospects.
- **Dynamic Adjustments:** Regularly update and adjust valuation models to reflect changes in market conditions and company performance, ensuring the accuracy and relevance of valuation results.

In conclusion, while the FCFF model provides a systematic approach to company valuation, it should be integrated with market data and industry trends to make informed investment decisions. Future research and practice can focus on refining and expanding valuation methods to adapt to evolving market conditions and company development needs.

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