

"FREE CASH FLOW" VS. "CAPITAL CASH FLOW"

Both Capital Cash Flows and Free Cash Flows are measures of cash flow to all suppliers of capital (debtholders and equityholders), so they are inputs to valuing the entire firm. Where they differ is the way in which they treat the tax benefits of deductible debt interest. When they are applied correctly, the two methods provide equivalent valuations.

	<u>CAPITAL CASH FLOW</u>		<u>FREE CASH FLOW</u>
ACCOUNTING MEASURE	EBIT		EBIT
TREATMENT OF DEPRECIATION	Add: Depreciation expense <i>(adjusting for an accounting deduction that did not involve a cash outflow)</i>		Add: Depreciation expense <i>(adjusting for an accounting deduction that did not involve a cash outflow)</i>
TREATMENT OF CAPITAL EXPENDITURES	Subtract: Capital Expenditures <i>(adjusting for a cash outflow that did not involve an accounting deduction)</i>		Subtract: Capital Expenditures <i>(adjusting for a cash outflow that did not involve an accounting deduction)</i>
TREATMENT OF CHANGE IN NET WORKING CAPITAL	Add: Decrease in NWC OR Subtract: Increase in NWC <i>(in effect, converts sales into cash receipts and inventory and payables into cash expenses)</i>		Add: Decrease in NWC OR Subtract: Increase in NWC <i>(in effect, converts sales into cash receipts and inventory and payables into cash expenses)</i>
TREATMENT OF TAXES	Subtract: Income Taxes [(EBIT - interest) x T _C] <i>(deducts taxes on ordinary taxable income, so treats tax benefits of debt in the cash flow measure)</i>		Subtract: "As-if" Income Taxes [EBIT x T _C] <i>(deducts taxes that would have been paid if firm were all-equity financed; treats tax benefits of debt in the discount rate)</i>
DISCOUNT RATE	r _A		WACC

The difference between Capital Cash Flow and Free Cash Flow is the interest tax shield.

$$\text{Capital Cash Flow} = \text{Free Cash Flow} + \text{Interest Tax Shield}$$