

11th WEEK ASSIGNMENT

Explain the difference between the operating income approach and the cost of capital approach?

Operating Income Approach

⇒ Estimates firm value based on expected operating income

⇒ Focuses on earnings potential.

⇒ Calculates value as:

$$\frac{\text{Operating Income} \times (1 - \text{Tax Rate})}{(\text{Required Return} - \text{Growth Rate})}$$

Cost of Capital Approach

⇒ Estimates firm value based on weighted average cost of capital

⇒ Considers both debt and equity costs

⇒ Calculate value as

$$\frac{\text{Free Cash Flow}}{(\text{WACC} - \text{Growth Rate})}$$