Class 10

UG3F14
Corporate Finance

Class 10 Topics and Content

- Capital Budgeting/Long-Term Investment Decision:

- Making Capital Investment Decisions: Project Analysis and Evaluation

Class 10

- ***Capital Budgeting/Long-Term Investment Decision:***

  - Making Capital Investment Decisions: Project Analysis and Evaluation

Volkswagen – VW Strategic Plan:
Volkswagen is committed to environmentally friendly, resource-efficient production, which is influenced by a whole array of factors. The environmental experts at Volkswagen use material flow analysis to gain a thorough insight into production processes around the globe.
source: www.volkswagenag.com

News:

1. *VW hiked its planned investment on digital and EV technologies to 73 billion euros ($86 billion) over the next five years, up from 60 billion euros. source: www.reuters.com*
2. *VW to invest $A118 billion in EV and digital technology in “race to keep up with Tesla*”**.** source: https://thedriven.io/

VW’s decision to develop and market green and digital technology represents a capital budgeting decision

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- ***Capital Budgeting/Long-Term Investment Decision:***

  - Making Capital Investment Decisions: Project Analysis and Evaluation

    - Difficulty in determining incremental cash flows

      - ✓ Cash Flows, NPV, discount rates, and rates of returns are critical inputs
      - ✓ Sunk costs - cost is a cost that has already occurred, are in the past, they cannot be changed by the decision to accept or reject the project. Example: consulting services paid to assess the viability of the project – they should not be considered initial investment
      - ✓ Opportunity costs: Assets that a business is considering selling, leasing, or employing elsewhere in the business but instead, the asset is used in a new project. Potential revenues from alternative uses are lost, and lost revenues can be viewed as costs (taking the project, the firm forgoes the other opportunities for using the assets)

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- ***Capital Budgeting/Long-Term Investment Decision:***

  ➢ Making Capital Investment Decisions: Project Analysis and Evaluation

  • Difficulty in determining incremental cash flows:

  Opportunity costs – alternative use of money: A business have a $1MM to invest and I decide to invest the money in the stock market, management then is committing the resources

  ✓ By investing $1MM in the stock market, the business will not be able to use the same $1MM for any other purposes

  ✓ Management must therefore ensure they are committing the resources to the best possible project within the same risk profile

  ✓ Opportunity cost of capital accounts for what businesses are foregoing to choose that best possible alternative

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- ***Capital Budgeting/Long-Term Investment Decision:***
  - ➢ Making Capital Investment Decisions: Project Analysis and Evaluation
    - Difficulty in determining incremental cash flows
      - ✓ Side effects of the proposed project on other parts of the firm in the form of erosion or synergy.
        - Erosion occurs when a new product reduces the sales and, the cash flows of existing products. For example, Walt Disney Company’s concerns when it built Euro Disney was that the new park would drain visitors from the Florida park.
        - Synergy occurs when a new project increases the cash flows of existing projects. For example, shavings supplies appears to lose money when launching a new razor, the increase in sales of its new razor blades may make the razor an overall winner for the firm

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- ***Capital Budgeting/Long-Term Investment Decision:***
  - ➢ Making Capital Investment Decisions: Project Analysis and Evaluation
    - • Difficulty in determining incremental cash flows
      - ✓ Allocation of Cost occurs when a particular expenditure benefits a number of projects, and costs are allocate proportionally across the different projects when determining income
      - ✓ Tax Expense – tax bracket and regulations
      - ✓ Interest Expense for projects that are financed or partially financed by debt

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- ***Capital Budgeting/Long-Term Investment Decision:***
  - Making Capital Investment Decisions: Project Analysis and Evaluation
    - Inflation and Capital Budgeting
      - ✓ Inflation an important part of Capital Budgeting
      - ✓ Interest rate and inflation
        - Example: Citizens Bank in Kenya offers a 1Y r interest rate of 10%, considered an interesting return. If inflation in the country is 6% affecting all goods and services in the country reducing your earnings to 4%*

          Real interest rate = Nominal interest rate - Inflation rate or 10%-6% = 4%

* Approximate formula not real rate

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- ***Capital Budgeting/Long-Term Investment Decision:***

  ➢ Making Capital Investment Decisions: Project Analysis and Evaluation

  The process for capital decision-making involves several steps, and a full due diligence process:

1. Identify and evaluate the required capital investments for sustainability and the potential opportunities for the business
1. Estimate operating and implementation costs of the projects
2. Estimate cash flow (economic) and potential benefits (reputational)
3. Assess risk thru the business risk management tools like decision trees or matrix
4. Implement the most beneficial project

* Approximate formula not real rate

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- ***Capital Budgeting/Long-Term Investment Decision:***

  ➢ Making Capital Investment Decisions: Project Analysis and Evaluation

  - Businesses need to establish a set of capital budgeting procedures to ensure that decisions are made in an orderly manner - annual capital budget
  - Annual Capital Budget is a list of investment projects planned for the future
  - Inclusion of a project in the capital budget does not constitute final approval for the expenditure
  - Before the plant or division can go ahead with a proposal, it will usually need to submit an appropriation request that includes detailed forecasts, a discounted-cash-flow analysis, and back-up information.

* Approximate formula not real rate

Class 9

The investment process starts with the preparation of an annual capital budget, which is a list of investment projects planned for the coming year

A firm's capital investment choices should reflect both bottom-up and top-down views of the business—capital budgeting and strategic planning, respectively

Capital budgeting must ignore sunk costs, whereas both opportunity costs and side effects must be considered