

FN 201: Lecture Note 8

The Basics of Capital Budgeting

Dr. Winai Homsombat

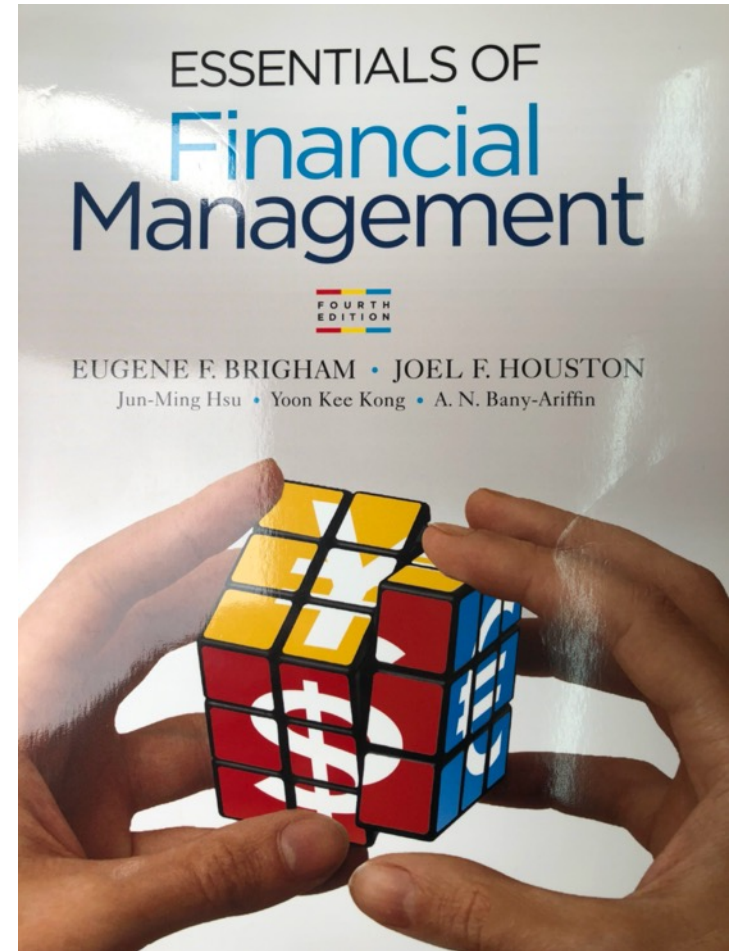
Bachelor of Economics, International Program

Thammasat University

Reading

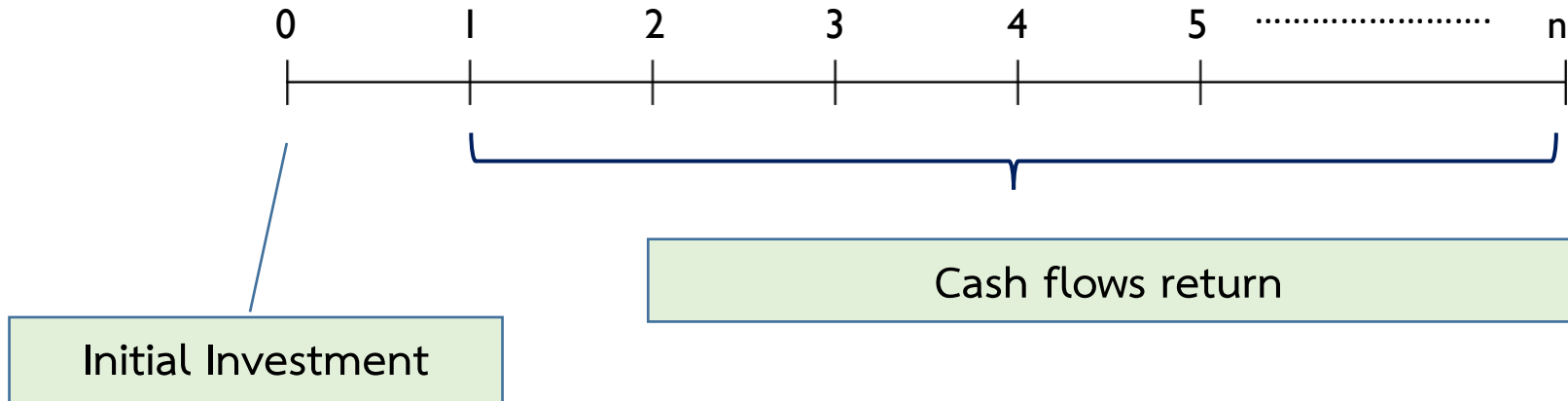
- Brigham, E.F., Houston, J.F., Hsu, JM., Kong, Y.K., Bany-Ariffin, A.N. (2018). Essentials of Financial Management. 4th Edition, Cengage Learning.

Chapter 12



Overview

Investment time line



Decision Tools

1. Net Present Value (NPV)
2. Internal Rate of Return (IRR)
3. Profitability Index (PI)
4. Payback period (PP)
 - Regular PP
 - Discounted PP

1 Net Present Value (NPV)

= PV value of a project's cash inflows minus PV of its costs (cash outflows)

$$\begin{aligned} NPV &= CF_0 + \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \dots + \frac{CF_N}{(1+r)^N} \\ &= \sum_{t=0}^N \frac{CF_t}{(1+r)^t} \end{aligned}$$

1 Net Present Value (NPV)

Example: Find Net Present Value of these projects when cost of capital = 18%

	Project A	Project B
Initial Investment	\$145,000	\$150,000
Year	Cash Inflow	
1	\$45,000	\$75,000
2	45,000	60,000
3	45,000	30,000
4	45,000	30,000
5	45,000	30,000
6	45,000	30,000

1 Net Present Value (NPV)

Decision criteria:

1. Independent projects

= cash flows of each project are not affected by the other

= unlimited resources => can choose any profitable projects

2. Mutually exclusive projects

= two different ways to accomplish the same result

= limited resources => can choose only the most profitable one

2 Internal Rate of Return (IRR)

= the discount rate that forces the PV of cash inflows to equal the PV of cash outflows

$$\begin{aligned} NPV &= CF_0 + \frac{CF_1}{(1 + IRR)^1} + \frac{CF_2}{(1 + IRR)^2} + \dots + \frac{CF_N}{(1 + IRR)^N} \\ &= \sum_{t=0}^N \frac{CF_t}{(1 + IRR)^t} = 0 \end{aligned}$$

Key Assumption

= Project cash flows can be reinvested at the same rate or at the IRR itself

2 Internal Rate of Return (IRR)

Trial and Error / Excel /
Calculator

Example: Find the Internal Rate of Return (IRR) of these projects

	Project A	Project B
Initial Investment	\$145,000	\$150,000
Year	Cash Inflow	
1	\$45,000	\$75,000
2	45,000	60,000
3	45,000	30,000
4	45,000	30,000
5	45,000	30,000
6	45,000	30,000

2 Internal Rate of Return (IRR)

Decision criteria:

1. Independent projects

IRR exceeds cost of capital

2. Mutually exclusive projects

Highest IRR project
from those exceed cost of capital

Note

Decision criteria:

1. Independent projects



NPV and IRR reach the same conclusion.

2. Mutually exclusive projects



NPV and IRR may result in conflicts!

Net Present Value vs. Internal Rate of Return

Decision for mutually exclusive projects

NPV vs. IRR

A) when cost of capital = 18%

NPV	A = \$12,392.12	B = \$14,609.20
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IRR	A = 21.28%	B = 22.71%
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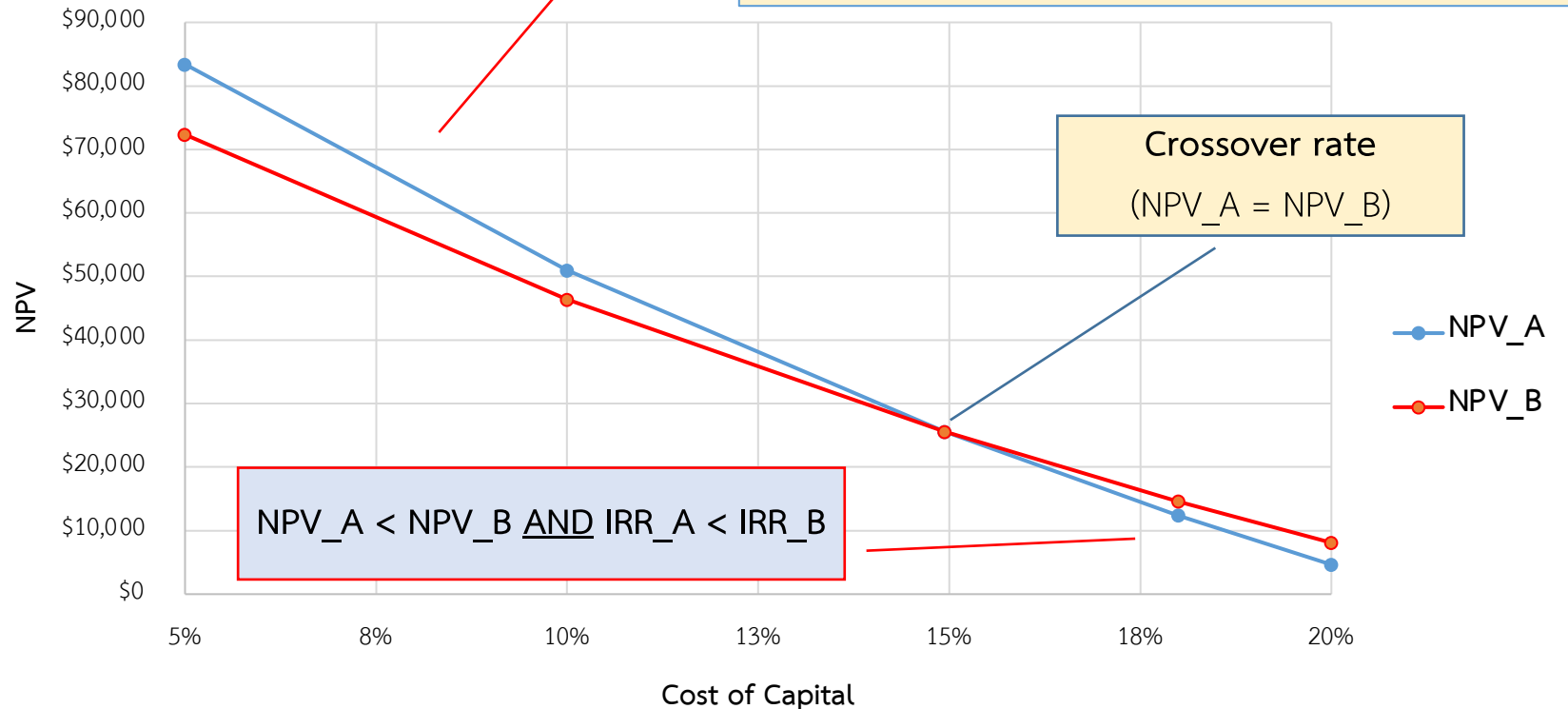
B) what if cost of capital = 5%

NPV	A = \$50,986.73	B = \$46,360.30
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IRR	A = 21.28%	B = 22.71%
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NPV vs. IRR

Net Present Value Profiles



NPV vs. IRR

Conflicts arise because:

1. Timing differences of project cash flows
2. Project size (initial investment) differences

Which one is better?

3 Profitability Index (PI)

$$PI = \frac{PV \text{ of future cash flow}}{\text{initial investment}} = \frac{\sum_{t=1}^N \frac{CF_t}{(1+r)^t}}{CF_0}$$

= relative profitability of the project

= present value per dollar of initial investment

3 Profitability Index (PI)

Example: Find the Profitability Index (PI) of these projects when cost of capital = 18%

	Project A	Project B
Initial Investment	\$145,000	\$150,000
Year	Cash Inflow	
1	\$45,000	\$75,000
2	45,000	60,000
3	45,000	30,000
4	45,000	30,000
5	45,000	30,000
6	45,000	30,000

4 Payback Period

= the number of years required to recover the fund invested in a project from its operating cash flows

$$\text{Payback} = \begin{array}{c} \text{Number of years} \\ \text{prior to full} \\ \text{recover} \end{array} + \frac{\begin{array}{c} \text{Unrecovered cost at} \\ \text{start of year} \end{array}}{\begin{array}{c} \text{Cash flow during full} \\ \text{recovery year} \end{array}}$$

Regular vs. Discounted
Payback Period ?

4 Payback Period

Example: Find the regular and discounted payback period of these projects given cost of capital = 18%

	Project A	Project B
Initial Investment	\$145,000	\$150,000
Year	Cash Inflow	
1	\$45,000	\$75,000
2	45,000	60,000
3	45,000	30,000
4	45,000	30,000
5	45,000	30,000
6	45,000	30,000

Question?