

FN201: Lecture Note 4

Time Value of Money

Winai Homsombat

Bachelor of Economics, International Program

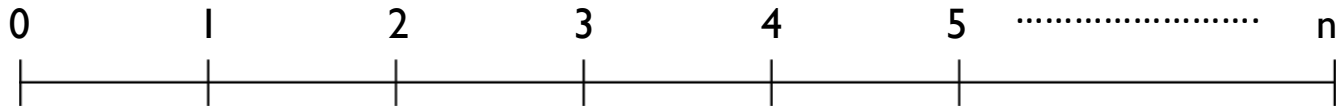
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Overview

Application:

Feasibility Analysis, Investment Analysis, etc.

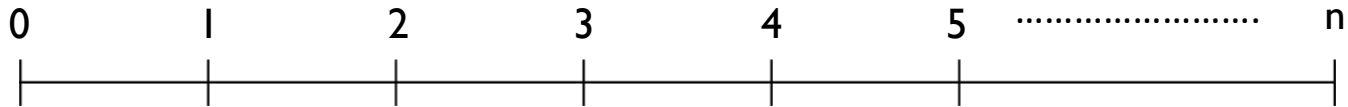
Investment time line



Future Value vs. Present Value

Investment time line

Present cash flow



Future cash flow

Cash Flows Pattern

1. Single sum
2. Annuity
3. Perpetuity
4. Uneven cash flows

Types of Interest

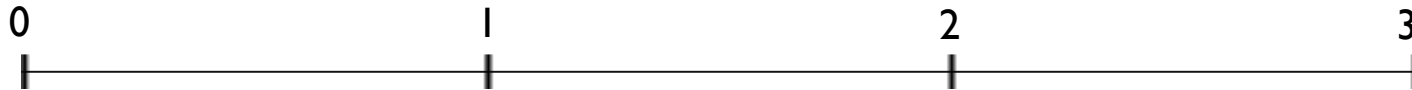
Example: What is the future value of \$10,000 for the next 3 year if interest is 5% for one year?

1. Simple interest

Principal = 10,000

Interest = = =

Future Value = = =



2. Compound interest

Principal = 10,000

Interest = = =

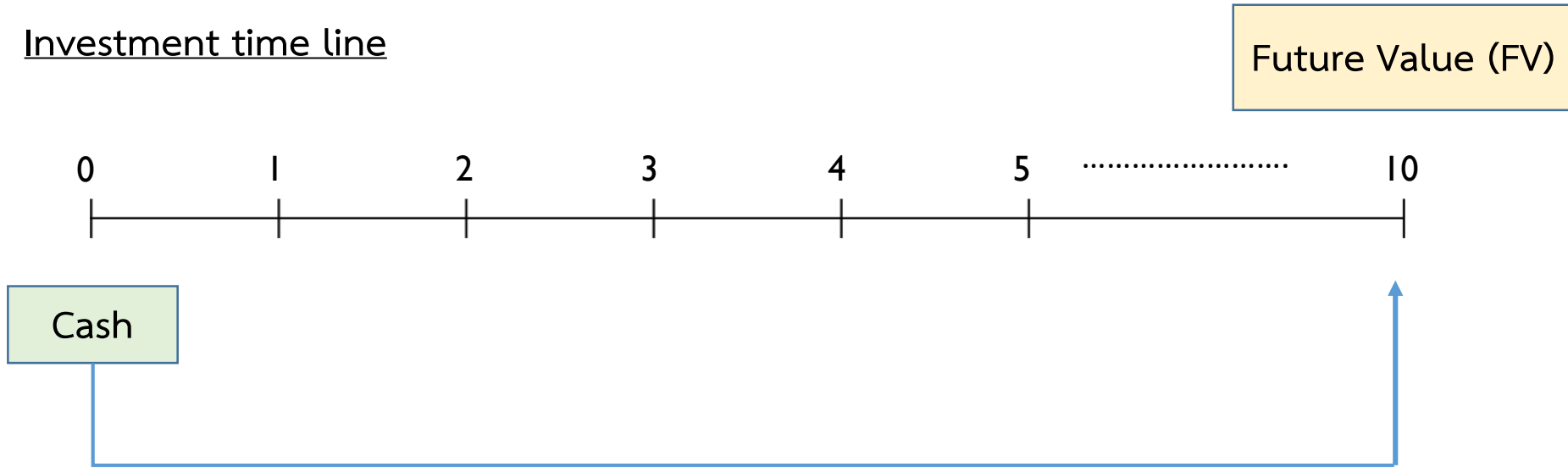
= = =

Future Value = = =

Single Sum Cash Flows:
Present Value and Future Value

Future Value

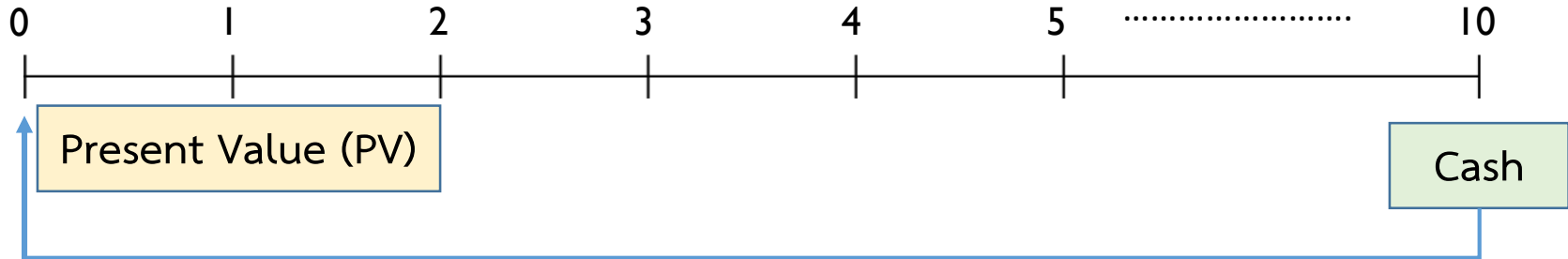
Investment time line



Example *What is the future value of \$400,000 if interest is compounded annually at a rate of 5% for one year? – Using Table (FVIF)*

Present Value

Investment time line



***Example** Tony plans to invest in one project which will bring back return at \$450,000 at the end of 8th year, what is the present value of that project? – Using Table (PVIF)*

Example – Single Cash Flow

1. Your favorite uncle has offered you the choice of the following options. He will give you either \$2,000 1 year from now or \$3,000 4 years from now. Which would you choose if the discount rate is (a) 10 percent? (b) 20 percent?
2. You have just received notification that you have won the \$1 million first prize in the Centennial Lottery. However, the prize will be awarded on your 100th birthday (assuming you're around to collect), 80 years from now. What is the present value of your windfall if the appropriate discount rate is 9 percent?

Example – Single Cash Flow

3. The first comic book featuring Superman was sold in 1938. In 2005, the estimated price for this comic book in good condition was about \$485,000. This represented a return of 18 percent per year. For this to be true, what must the comic book have sold for when new?
4. You're trying to save to buy a new \$170,000 Ferrari. You have \$40,000 today that can be invested at your bank. The bank pays 6 percent annual interest on its accounts. How long will it be before you have enough to buy the car?

Example – Single Cash Flow

5. As part of your financial planning, you wish to purchase a new car exactly 5 years from today. The car you wish to purchase costs \$14,000 today, and your research indicates that its price will increase by 2% to 4% over the next 5 years due to inflation.
- Estimate the price of the car at the end of 5 years if inflation is (1) 2% per year, and (2) 4% per year.
 - How much more expensive will the car be if the rate of inflation is 4% rather than 2%?
 - If return from saving in bank is 8%, how much should you save money to get a new car at the end of 5th year if inflation is (1) 2% per year, and (2) 4% per year?

Annuity Cash Flows:
Present Value and Future Value

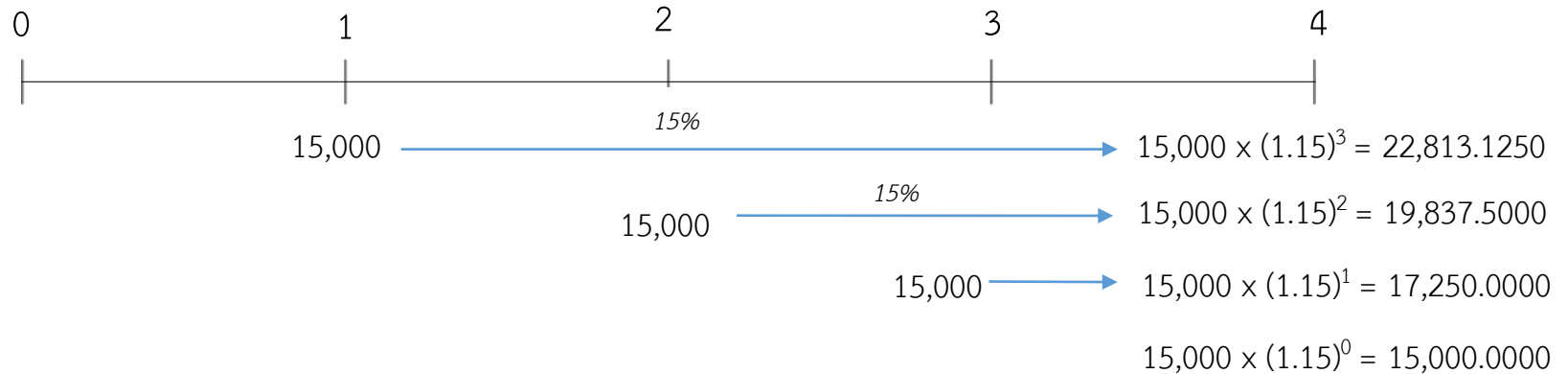
Future Value and Present Value for Annuities Due

Ordinary Annuities = Payment at the end of period

Annuities Due = Payment at the beginning of period

Future Value

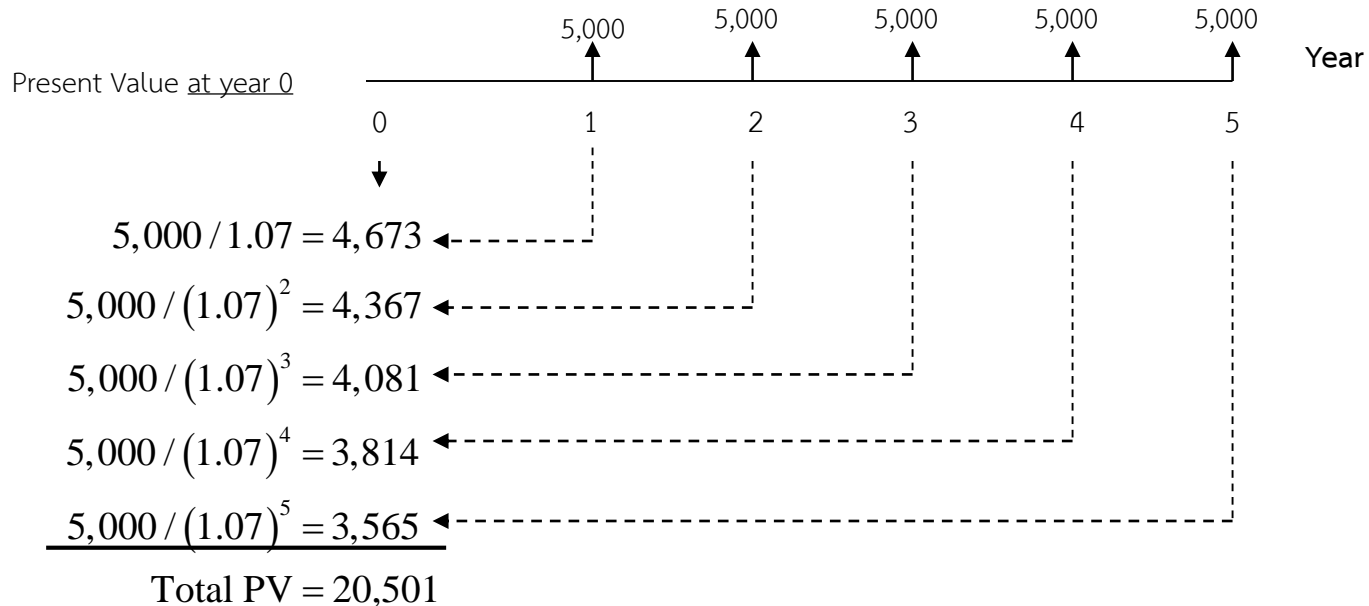
Assume that BMX company receives annuity cash flows from project invested \$15,000 at the end of each year until 4th year with an annual growth rate 15%. Find future value at the end of 4th year?



Present Values

Example

Tiburon Autos offers you “easy payments” of \$5,000 per year, at the end of each year for 5 years. If interest rates are 7%, per year, what is the cost of the car?



Example – Ordinary Annuities

1. Your father is about to retire. His firm has given him the option of retiring with a lump sum of \$20,000 or an annuity of \$2,500 for 10 years. Which is worth more now, if an interest rate of 6 percent is used for the annuity?
2. You need to have \$50,000 at the end of 10 years. To accumulate this sum, you have decided to save a certain amount at the *end* of each of the next 10 years and deposit it in the bank. The bank pays 8 percent interest compounded annually for long-term deposits. How much will you have to save each year (to the nearest dollar)?

Example – Ordinary Annuities

3. David and Helen Zhang are saving to buy a boat at the end of five years. If the boat costs 20,000 and they can earn 10% a year on their savings, how much do they need to put aside at the end of years 1 through 5?
4. Kangaroo Autos is offering free credit on a new \$10,000 car. You pay \$1,000 down and then \$300 a month for the next 30 months. Turtle Motors next door does not offer free credit but will give you \$1,000 off the list price. If the rate of interest is 10% a year, (about 0.83% a month) which company is offering the better deal?

Future Value and Present Value for Annuities Due

Ordinary Annuities = Payment at the end of period

Annuities Due = Payment at the beginning of period

Future value of Annuities Due

$$= \text{Cash flows} \times (\text{FVIFA}_{r\%,n}) \times (1+r)$$

Present value of Annuities Due

$$= \text{Cash flows} \times (\text{PVIFA}_{r\%,n}) \times (1+r)$$

Future Value and Present Value for Annuities Due

Example:

Answer the questions that follow:

Case	Amount of Annuity	Interest	Period (Years)
A	2,500	8%	10
B	500	12%	6
C	30,000	20%	5
D	11,500	9%	8
E	6,000	14%	30

- Assume you deposit the amount of annuity, calculate the future value when it is (1) an ordinary annuity, and (2) an annuity due.
- Assume you have the annuity return from investment, calculate the present value when it is (1) an ordinary annuity, and (2) an annuity due.
- Compare the finding in parts a.1 vs. a.2, and b.1 vs. b.2. All else being identical, which type of annuity – ordinary or annuity due – is preferable? Why?

Present Value of Perpetuity Cash Flows

Present Value of Perpetuity Cash Flows

Regular perpetuity



Present Value of Perpetuity Cash Flows

Example:

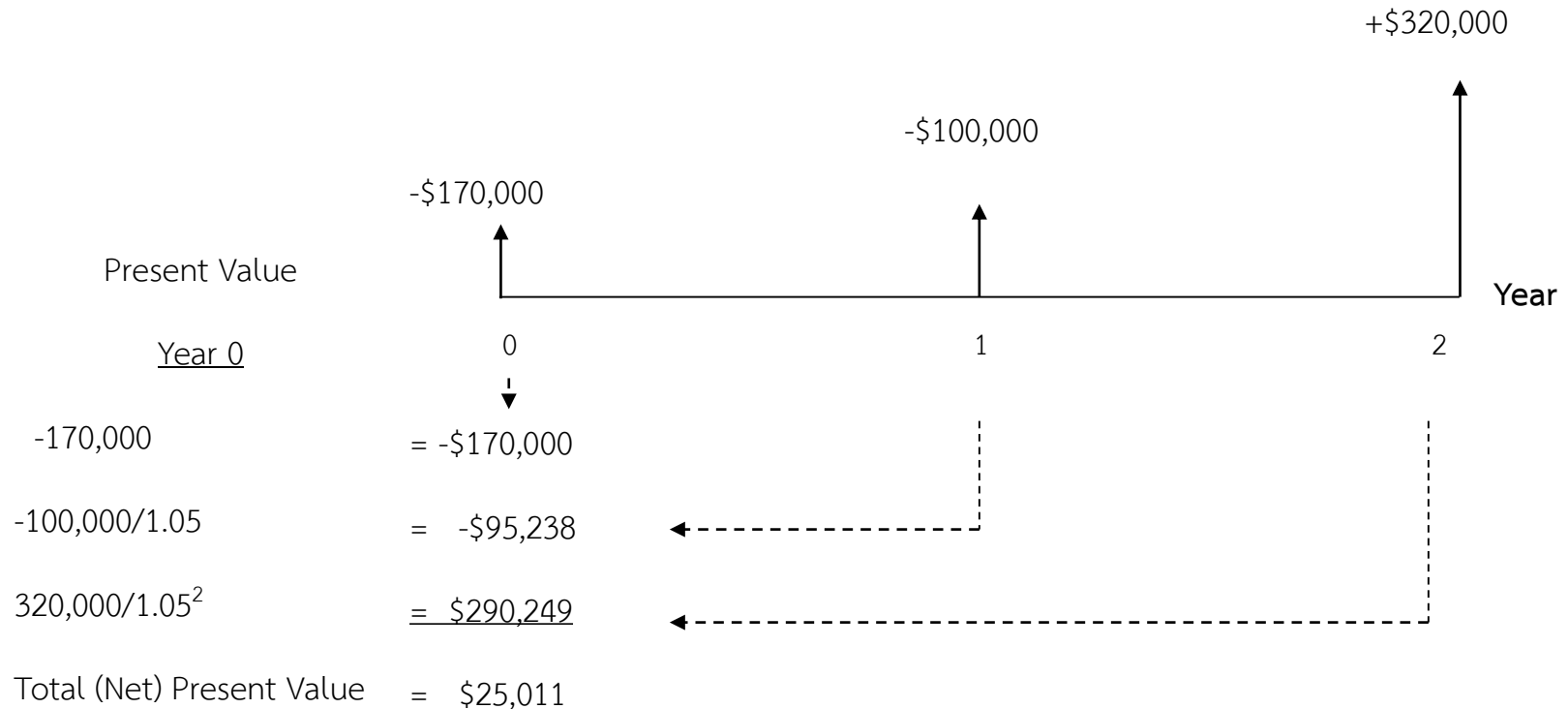
1. What is the present value of a perpetuity of \$80 per year if the discount rate is 11 percent?
2. You want to invest in long-lived company with perpetuity dividend and risk (as presented by different values of discount rates) as below table. Which company would bring you highest present value?

Company	Annual amount	Interest
A	20,000	8%
B	100,000	10%
C	3,000	6%
D	60,000	5%

Present Value of Uneven Cash Flows

Present Value of Uneven Cash Flows

Assume that the cash flows from the construction and sale of an office building is as follows. Given a 5% required rate of return.



Present Value of Uneven Cash Flows

Example:

1. Candy Parker has been offered an opportunity to receive the following mixed stream of revenue over the next 3 years. What is present value of this opportunity given interest rate at 15%?

Year	Annual amount
1	1,000
2	2,000
3	500

Present Value of Uneven Cash Flows

Example:

2. As a financial consultant for ABCCompany, which project results in the most profitable (Hint: by calculating present value of the streams of cash flows). Assume that the firm's opportunity cost is 12%.

A		B		C	
Year	Cash Flows	Year	Cash Flows	Year	Cash Flows
1	-2000	1	10000	1-5	10000/year
2	3000	2-5	5000/year	6-10	8000/year
3	4000	6	7000		
4	6000				
5	8000				

Question?