

Investment appraisal under uncertainty

Finance



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work, Finance and Accounting Investment Appraisal under Uncertainty Table
for Cash Flows TWO STAGE DISCOUNTING CASH FLOW

Initial Cash Flow

\$100, 000, 000

Years:

1 - 3

4 - 6

Rate of Growth

10%

10%

Final Growth Rate:

1%

Discounting Rate:

15%

Outstanding Shares :

10, 000, 000

Safety Margin:

30%

Level of Debts:

\$0

Pay Back Year

Flows

Growth

Value

1

110, 000, 000

10%

\$95, 652, 174

2

121, 000, 000

10%

\$91, 493, 384

3

133, 100, 000

10%

\$87, 515, 411

4

145, 813, 619

10%

\$83, 369, 410

5

159, 741, 634

10%

\$79, 419, 824

6

175, 000, 043

10%

\$75, 657, 348

Terminal Year NPV

\$1, 750, 000

PV of Yr 1 to 6 Cash Flows:

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\$513, 107, 550

Terminal Value:

\$5, 404, 096

Total Cash Flow PVs:

\$518, 511, 646

NO of Shares

10, 000, 000

Intrinsic Value:

\$51. 85

Intrinsic Value Safety Margin

\$36. 30

% age Intrinsic Value from the Terminal Value

1%

Table 1: Cash Flow Discounting

Reasons for Reluctance

One of the reasons for being reluctant in decision-making on the investment is the uncertainties related to the discounting of cash flows. Discounting implies that the future cash flows of the company have been discounted back to its current position to determine the company's valuation. The Discounting Cash Flow Model is not reliable as a perfect tool for valuation because it is practically not able to predict the growth rate of the company's cash flows. However, it can give an estimate of the value of the company in combination with other parameters.

Secondly, reluctance to invest is justifiable because it compels the user to keep in mind the Intrinsic Value of the investment. Intrinsic value is merely a numbers introduced into this model. It is possible for one to assume

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unrealistic terminal value based on overstated or understated growth rates. According to Nitzan and Bichler (2009), this generates unrealistic intrinsic value outcomes.

The third reason for reluctance is the Limitations of Discounting Cash Flow Model in relation to the payback period. It can only function for a limited number of years, suitably, 5-year time payback period. Again, it cannot function if the growth rate is higher than the discounting rate (Nitzan & Bichler, 2009).

References

Nitzan, J. & Bichler, S. (2009), *Capital as Power. A Study of Order and Creorder.*, RIPE Series in Global Political Economy, New York and London: Routledge.