

Capital projects and strategic direction



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Organizations undertake different projects in order to add more value to their production capacity and to expand into new or existing markets. The basis or the criteria under which the organizations decide to take on any new project is based on its value generating capability for the firm and the shareholders. The ultimate aim of the management of the firm is to add value to the shareholders and the firm and therefore all the decisions made by the management of the firm always revolve around the maximization of the firm's value. Any decision which does not result into the addition of value of the firm therefore shall not be undertaken as such decisions are considered as detrimental to the firm value. (Bender & Ward, 2002) A typical process to evaluate a project involves assessing its net present value by discounting the future cash flows of a firm with appropriate discount rate and deducting the resulting amount from the total capital outlay spent on the project. If the net present value of the project is positive it adds value to the firm and if it is negative, it could not add value to the firm. The value addition proposition of the capital projects is therefore their net present value. If the net present value is positive, it adds value to the firm and the shareholders. Positive NPV of the project therefore is considered as the key criteria for adding value to the firm. If NPV of the capital project is negative, it is assumed that it will not add value to the firm and hence could not maximize the value of the firm or the value for the shareholders. Major capital projects with positive NPV help the organization's stock prices to increase by such projects give a signal to the investors that the firm is adding more capacity to it and expanding its markets. Expansion through new capital projects therefore also allow the firms to increase the future cash flow generation of the firm and hence increase their share prices also. Since

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share prices are also determined by discounting the future cash flows therefore if investors anticipate that the future cash flows will be positive and large, it becomes highly probable that the prices of such shares will increase over the period of time. Capital projects fits into the overall strategic direction of the firm is achieved when it can create synergies for the firm or add more value to it. If the firm's overall strategic orientation is to achieve the growth through either organic or other methods of expansion than such projects can easily fit into the overall strategic direction of the firm. Creation of synergies is considered as essential criteria to judge whether the addition of a new project will create synergies for the firm and will result into the better processes and procedures for the firm. If any capital project cannot create synergies its highly unlikely that such projects will fit into the overall strategic direction of the firm. (Lin & Kulatilaka, 2007)

Bibliography Bender, R., & Ward, K. (2002). *Corporate Financial Strategy*. New York: Butterworth-Heinemann. Lin, L., & Kulatilaka, N. (2007). Strategic options and firm value. *Managerial Finance*, 33(11) , 58-65.