The investment detective - finance 17

Finance

The Investment Detective The Investment Detective - Finance Case 17 Question These projects can not just be ranked by simpleinspection of the cash flows. It is, therefore, advisable to bring all the cash flows to the present time before comparing them. This is of necessity due to the time value of money. For instance, a dollar that is currently available is more valuable than a dollar that is expected sometimes in the future (Baker, 2011). The cash flows should, therefore, be brought to the present before the projects are ranked.

Question # 2

Careful examination of the projects shows that there are various criteria that can be applied in ranking the projects. The project's Payback period, Net Present Value (NPV) and Internal Rate of Return (IRR) are some of the key criteria that can be used. However, NPV provides the best ranking criteria, since IRR is only applicable when there are series of cash flows that indicate results in an initial outlay followed by future inlay (Baker, 2011). A series of cash flows that do not satisfy this requirement, will not give appropriate results with the IRR method. IRR method also gives percentages which do not include the magnitude of cash flows (Baker, 2011). Payback method normally overlooks the time value of money. This is one of its main drawbacks in ranking projects. The drawbacks of Payback period and IRR method make NPV the best method for capital budgeting (Baker, 2011).

Question # 3

The ranking that I established by using the quantitative method is as follows:

Projects ranked by using NPV methods

1) Project 6 2) Project 2 3) Project 7 4) Project 4

Projects ranked by using IRR method

1) Project 6 2) Project 2 3) Project 7 4) Project 4

Projects ranked by using Payback Method

1) Project 6 2) Project 2 3) Project 7 4) Project 4

This ranking significantly differs from the ranking done by ordinary inspection of the cash flows. Ranking by ordinary inspection of cash flows gives:

1) Project 32) Project 23) Project 6 4) Project 7

Question # 4

Project 1 relates to the investment in a coupon bond, where coupon payments are received periodically at the end of the period when principal is received (Baker, 2011).

Project 3 is similar to zero coupon bonds, where the bond can be purchased at specified prices, and a significant cash outflow is received at the end of the maturity period (Baker, 2011).

Project 2 and 6 relate to actual venture capital project in which, bulks of cash inflows are realized at the end of maturity period, but some cash inflows can also occur at the beginning of the period (Baker, 2011).

Project 5 relates to annuity.

Project 4, 7 and 8 relate to an investment in machinery where positive cash is generated at a certain period of time. After some times, they can be sold so as to generate more cash. Additional cash flows are incurred at the beginning of the period to keep the machinery going (Baker, 2011).

Reference

Baker H. K. (2011). Capital Budgeting Valuation: Financial Analysis for Todays Investment Projects. New York: John Wiley and Sons.