

Capital projects recommendation 2

Finance



Assumptions: Business Owners: Founders and Investors Projects:

Management evaluated a set of capital investment project. Project category:

Establish a fully equipped facility with planned expansion

Tasks: Recommendations to the owners on Capital Investment projects.

The project under consideration is a capital investment plan (“ Investment decision – Capital Budgeting”). The project will be implemented in two stages; stage 1 – construction of the fully equipped for production a facility, stage 2-planned expansion of the facility. I will consider the following factors before planning and recommendation; initial investment, operating cash flow (OCF), terminal cash flow, cost of capital, opportunity cost, and break-even point. Initial investment includes; cash outlay, working capital, salvage value and tax implications. Operating cash flows includes; sales revenue, cost of production, income before taxes, marginal tax rate, depreciation, increase in working capital. Terminal cash flow includes; decrease in working capital, salvage value, marginal income tax rate. Cost of capital evaluates the cost of borrowing to pay for the project. This value is set as the benchmark for the lowest possible return. Opportunity cost determines the cost for taking advantage of one option over another. Break-even point determines if the project would contribute to the growth of the company.

Capital budgeting technique uses different formulas for analysis of financial values to determine if a company should proceed with the planned investment or not. These formulas contain various parameters, and they have specific concepts. These parameters are Net Present Value (NPV), Internal Rate of Return (IRR), and Payback method. Embedded concepts of these parameters helped me evaluating fully equipped facility cost. Capital budgeting technique requires calculating OCF. All three parameters; NPV,

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IRR, and Payback use OCF values. NPV evaluates present value of the future cash flows that the project generates during its life (“What is NPV”). In simple language if the value of money generated during the project life is higher than the initial investment, the project makes money. IRR determines (Mohr) the cost of return at which all cash inflows (revenues) equals the present value of cash outflows (initial investment plus any other expenses). In other way, it is the cost of capital at which NPV is zero. Hence, if IRR is higher than the cost of capital, the project is making money. Payback period calculates the length of the time it will take to get back company’s initial investment. In other words, this method defines how long would it take to get the investment money back.

These three parameters tell me; (1) how long would it take to get the initial investment back, (2) how much money the project will create during the life cycle, (3) and if projects return rate is higher than the cost of capital.

Reference

Investment decision – Capital Budgeting. (n. d.). FAO CORPORATE DOCUMENT REPOSITORY. Retrieved from <http://www.fao.org/docrep/W4343E/w4343e07.htm>

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