Chapter 17
Expanding the Business

Learning Objectives

1. Describe the tasks necessary to make business investment decisions.
2. Explain how capital budgeting can be used by a firm to determine whether it should invest in a project.
3. Describe the factors that motivate investment in other firms (acquisitions).
4. Explain how firms make decisions for investing in short-term assets.

Investments

- Revenue resulting from the firm’s investments in its business operations
- Expenses resulting from the firm’s investments in its business operations
- Firm’s Earnings
- Firm’s Value

Business Investment Decisions

- To decide if a project should be implemented, firms conduct Capital Budgeting, which is a comparison of costs and benefits.
- The costs include the initial payment for the project and the periodic maintenance costs.
- The benefits are the revenue a project will generate.

Capital Budgets and Purchasing

- Buildings
- Machinery
- Equipment

Classification of Capital Expenditures

- Expand current business.
- Develop new business.
- Invest in assets to reduce expenses.
Capital Budgeting Tasks

1. Propose new projects.
2. Estimate cash flow.
3. Determine feasibility of projects.
4. Implement feasible projects.
5. Monitor implemented projects.

Present Value of Money (NPV)

- Money has a time value.
- Payments received in the future have less value than payments received today.
- Payments received in the future must be discounted to determine their present value.

Present Value of Money

Example:
Present value (PV) of a $50,000 payment to be received in one year (assuming a return rate of 10%): $50,000
PV = \( \frac{50,000}{(1 + .10)^1} \) = $45,455

Present Value of Money

Example:
Firm can invest in a project today that would generate a cash flow of $10,000 from the investment in one year. Required rate of return is 12%:
$10,000
PV = \( \frac{10,000}{(1 + .12)^1} \) = $8,929
1 = 1 year later

Estimating Net Present Value

\[
PV = \frac{8,000}{(1 + .15)^1} + \frac{12,000}{(1 + .15)^2} = $16,031
\]

Net Present Value = Present Value - Initial Outlay
\[
NPV = PV - I
\]
\[
NPV = $16,031 - $15,000 = $1,031
\]

When the net present value is positive, the present value exceeds the initial outlay, and the project is feasible.

Four Reasons For Mergers

- Immediate growth.
- Economies of scale.
- Seeking managerial expertise.
- Tax benefits.
How Acquisition Can Generate Economies of Scale

<table>
<thead>
<tr>
<th>Firm</th>
<th>Total Output Produced</th>
<th>Variable Cost per Unit</th>
<th>Variable Cost</th>
<th>Fixed Cost [Total]</th>
<th>Total Cost</th>
<th>Average Cost per Unit</th>
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<tbody>
<tr>
<td>A</td>
<td>500 units</td>
<td>$10</td>
<td>$5,000</td>
<td>$6,000</td>
<td>$11,000</td>
<td>$22.00</td>
</tr>
<tr>
<td>B</td>
<td>400 units</td>
<td>$10</td>
<td>$6,000</td>
<td>$6,000</td>
<td>$12,000</td>
<td>$25.00</td>
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<tr>
<td>A &amp; B Combined</td>
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<td>$10</td>
<td>$11,000</td>
<td>$15,000</td>
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<td>$16.67</td>
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Merger

- **Vertical**: The combination of a firm with a potential supplier or customer.

  - Bicycle Company + Wheel Company

- **Horizontal**: Combination of firms in the same types of business.

  - Bicycle Company + Scooter

- **Conglomerate**: Combination of two firms in unrelated businesses.

  - Airlines + Bicycle Company

Leveraged Buyout (LBO)

- An attempt by employees, management or a group of investors to purchase an organization through borrowed funds.
- Could be result of employees fearing the loss of their jobs.
- Managers may feel corporate performance would be better if they owned the firm.

Leveraged Buyouts

**Advantage**:
- Ownership is restricted to a small group of people.
- Allows for the potential for high returns to the owners.

**Disadvantage**:
- Puts a strain on cash.
- Because of the high degree of financial leverage they are risky.
Three Reasons for Divestitures

Divestiture: the sale of an existing business by the firm.
1. Eliminate non-core operations.
2. Obtain funds.
3. Higher “break-up” value.

Segments of Working Capital Management

- Liquidity management.
- Accounts receivable management.
- Inventory management.