Chapter 17

Expanding the Business

Learning Objectives

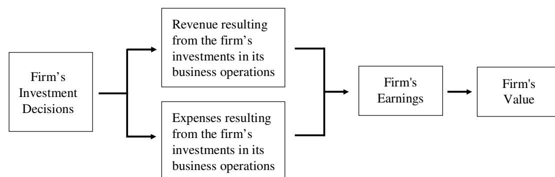
❶ Describe the tasks necessary to make business investment decisions.

❷ Explain how capital budgeting can be used by a firm to determine whether it should invest in a project.

❸ Describe the factors that motivate investment in other firms (acquisitions).

❹ Explain how firms make decisions for investing in short-term assets.

Investments



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%):

$$PV = \frac{\$50{,}000}{(1 + .10)^1} = \$45{,}455$$

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%:

$$PV = \frac{\$10{,}000}{(1 + .12)^1} = \$8{,}929$$

1 = 1 year later

Estimating Net Present Value

$$PV = \frac{\$8{,}000}{(1 + .15)^1} + \frac{\$12{,}000}{(1 + .15)^2} = \$6{,}957 + \$9{,}074 = \$16{,}031$$

Net Present Value = Present Value - Initial Outlay

NPV = PV - I

NPV = $16,031 - $15,000

NPV = $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

❶ Immediate growth.
❷ Economies of scale.
❸ Seeking managerial expertise.
❹ Tax benefits.

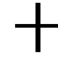
How Acquisition Can Generate Economies of Scale

Firm	Total Output Produced	Variable Cost per Unit	Variable Cost	Fixed Cost (Rent)	Total Cost	Average Cost per Unit
A	500 units	$10	$5,000	$6,000	$11,000	($11,000/500) = $22.00
B	400 units	$10	$4,000	$6,000	$10,000	($10,000/400) = $25.00
A & B Combined	900 units	$10	$9,000	$6,000	$15,000	($15,000/900) = $16.67

Exhibit 17.6

Merger

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



Buys

Bicycle Company **Wheel Company**

Merger

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

Buys

Bicycle Company **Scooter**

Merger

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

Buys

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.

❶ Eliminate non-core operations.

❷ Obtain funds.

❸ Higher “break-up” value.

Segments of Working Capital Management

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