

Chapter 06:

The Fundamentals of capital budgeting

Section 01:

capital budgeting process

Capital Budgeting Process and Strategic Considerations

1. Capital Budgeting Process Framework and Implementation Stages

Stage 01: Project Identification and Screening

Stage 02: Detailed Financial and Risk Analysis

- Develop detailed financial models projecting cashflows
- Calculate NPV and IRR

Stage 03: Approval and Authorization

Stage 04: Implementation Planning

Capital Budgeting Process and Strategic Considerations

2. Pre-Implementation Strategic Analysis and Planning

Conducting SWOT Analysis for Investment Screening

Applying PESTEL Analysis for Macro-Environmental Assessment

Applying Portfolio Analysis for Resource Allocation

Assessing Stakeholder Impact

Evaluating Strategic Options

Capital Budgeting Process and Strategic Considerations

3. Implementation Management and Execution Oversight

Project Planning and Scheduling

Budget Control and Variance Analysis

Milestone Monitoring and Performance Measurement

Quality Assurance and Control

Capital Budgeting Process and Strategic Considerations

4. Post-Implementation Review and Performance Assessment

- Financial Performance Audit
- Strategic Objectives Assessment
- Process and Execution Evaluation
- Lessons Learned Documentation

STRATEGIC OBJECTIVE	TARGET METRIC	ACTUAL RESULT	STATUS
Increase Market Share Expand presence in target segments	5% Increase Year-over-year growth	6% Increase +1% above target	✓ACHIEVED
Improve Customer Satisfaction Enhance service quality metrics	NPS Score: 70 Net Promoter Score	NPS Score: 75 +5 above target	✓ACHIEVED
Enhance Operational Efficiency Reduce process cycle times	20% Reduction In average processing time	15% Reduction -5% below target	~ PARTIAL
Boost Employee Engagement Improve workforce satisfaction	85% Engagement Annual survey score	72% Engagement -13% below target	✗ NOT ACHIEVED
Strengthen Innovation Pipeline New product development initiatives	3 New Products Launched to market	4 New Products +1 above target	✓ACHIEVED
SUMMARY: Achieved: 3 Partial: 1 Not Achieved: 1 Overall Achievement Rate: 70%			

Section 02:

capital budgeting decision methods

Operating cashflow calculation

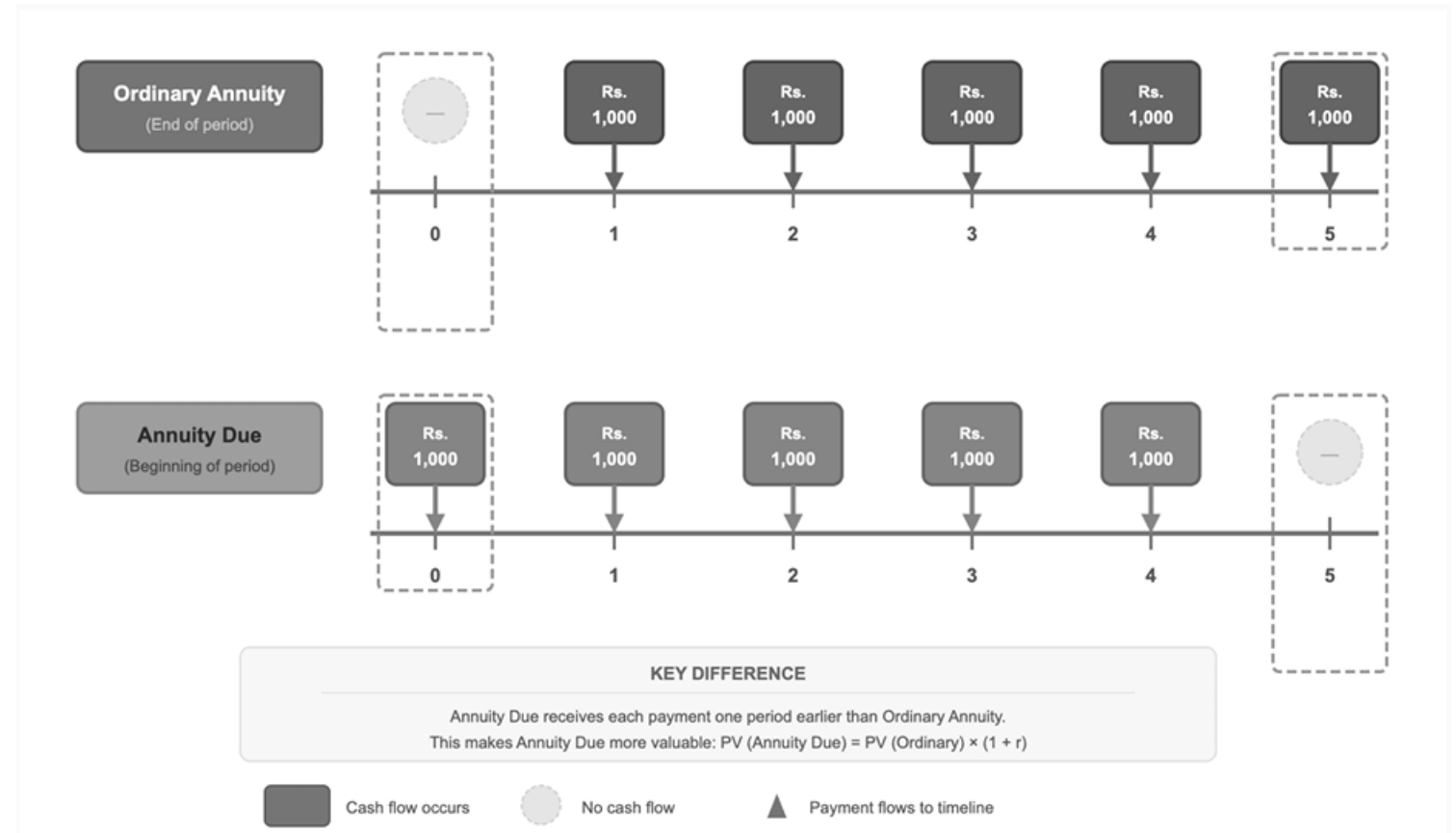
Operating Cash Flow Calculation Template	
Description	Amount (Rs. '000)
Sales Revenue	10,000
Operating Costs	(6,000)
EBITDA	4,000
Depreciation	(1,000)
EBIT	3,000
Tax (30%)	(900)
NOPAT	2,100
Add Back Depreciation	1,000
Operating Cash Flow	3,100

annuity

Consistent, periodic cashflows are called an annuity. There are two types of annuities: ordinary annuity and annuity due.

PV of an Annuity

$$PV = C \times \left[\frac{1 - (1 + r)^{-n}}{r} \right]$$



perpetuity

An annuity in which periodic payments begin on a fixed date and continue indefinitely.

PV of a perpetuity: $PV = PMT/i$

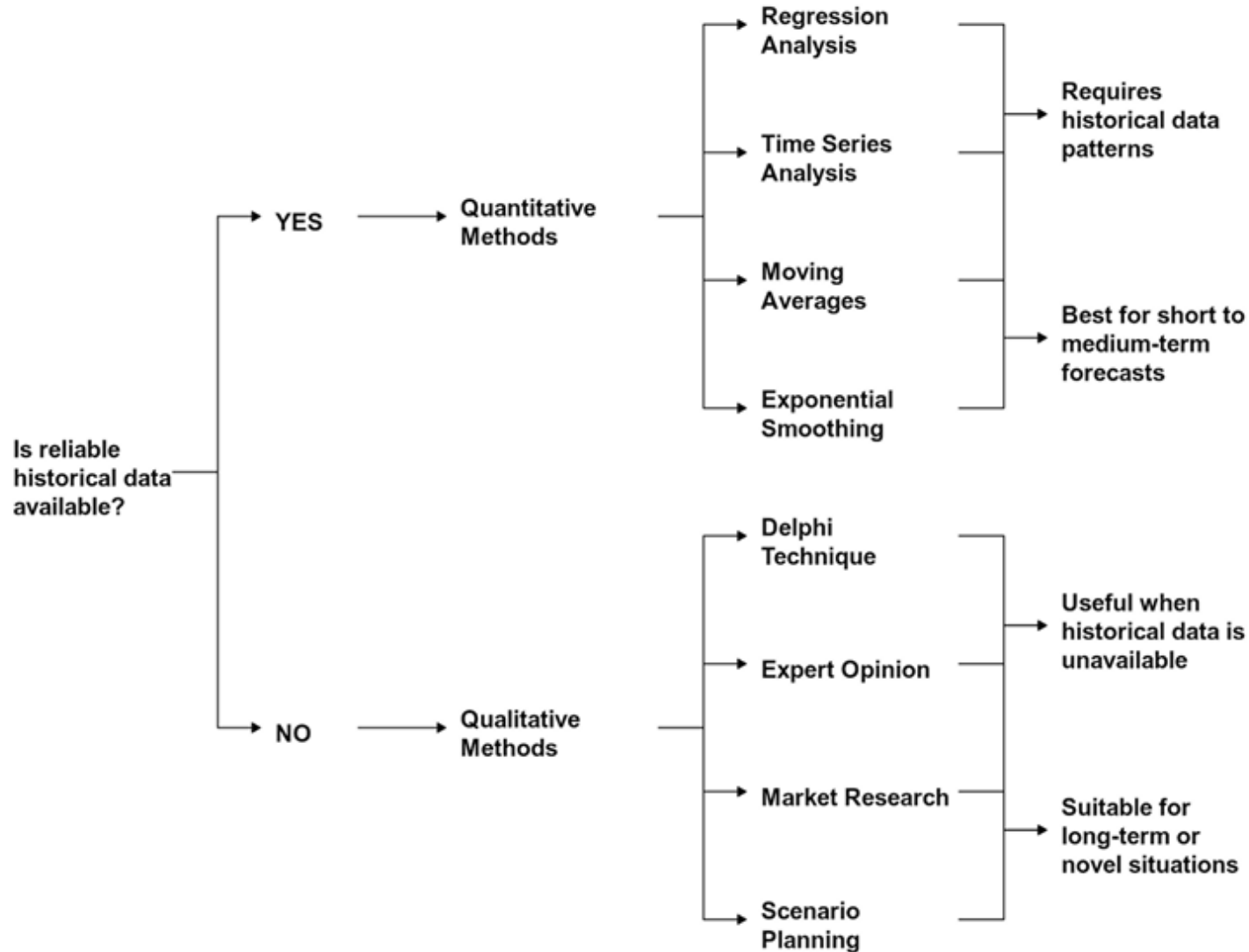
PV of a growing perpetuity:

$$PV = \frac{PMT_1}{i - g}$$

Example 01: A company holds preference shares paying a fixed annual dividend of Rs. 50,000 forever. If the required rate of return is 10%, calculate the present value of the perpetuity.

Example 02: A company holds an investment which gives annual returns which is expected to grow at 3% every year forever. Last year the return was Rs 50,000. What is the present value of the growing perpetuity if the required rate is 10%.

Cash Flow Estimation Techniques



Terms

Cannibalization: The reduction in existing product sales caused by introducing a new product. Should be included in the project evaluation cashflows.

Sunk cost: Sunk cost is money that has already been spent and cannot be recovered, regardless of your project decision. Sunk cost should be excluded from the project evaluation cashflows.

Opportunity Cost: The value of the best alternative foregone when making a choice. Should be included in the project evaluation cashflows.

Synergy: The additional value created when a new project enhances existing operations. Should be included in the project evaluation cashflows.