

III. Project Options

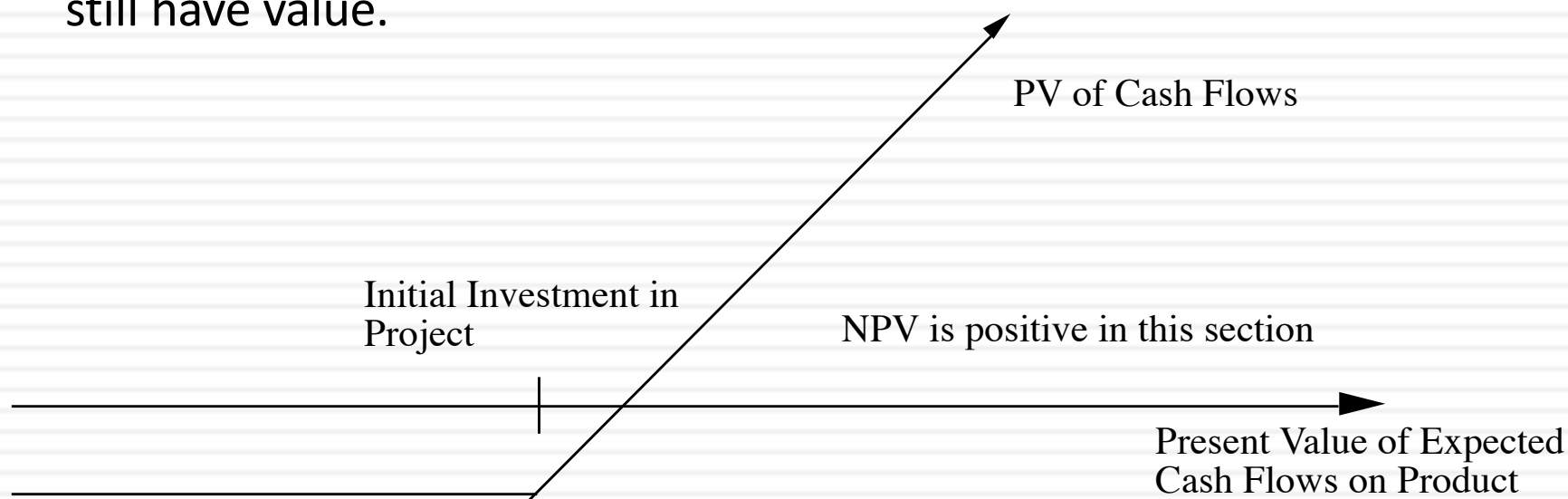
328

- One of the limitations of traditional investment analysis is that it is static and does not do a good job of capturing the options embedded in investment.
 - ▣ The first of these options is the option to delay taking a project, when a firm has exclusive rights to it, until a later date.
 - ▣ The second of these options is taking one project may allow us to take advantage of other opportunities (projects) in the future
 - ▣ The last option that is embedded in projects is the option to abandon a project, if the cash flows do not measure up.
- These options all add value to projects and may make a “bad” project (from traditional analysis) into a good one.

The Option to Delay

329

- When a firm has exclusive rights to a project or product for a specific period, it can delay taking this project or product until a later date. A traditional investment analysis just answers the question of whether the project is a “good” one if taken today. The rights to a “bad” project can still have value.



Insights for Investment Analyses

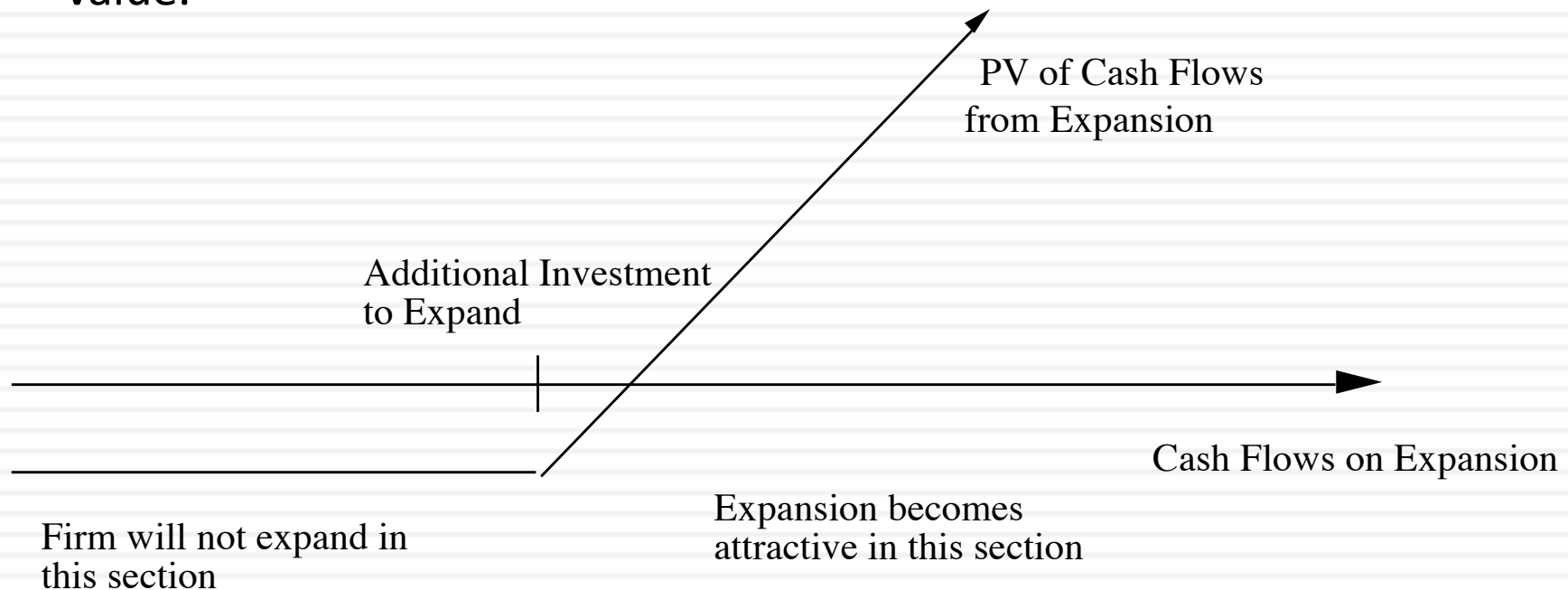
330

- Having the exclusive rights to a product or project is valuable, even if the product or project is not viable today.
- The value of these rights increases with the volatility of the underlying business.
- The cost of acquiring these rights (by buying them or spending money on development - R&D, for instance) has to be weighed off against these benefits.

The Option to Expand/Take Other Projects

331

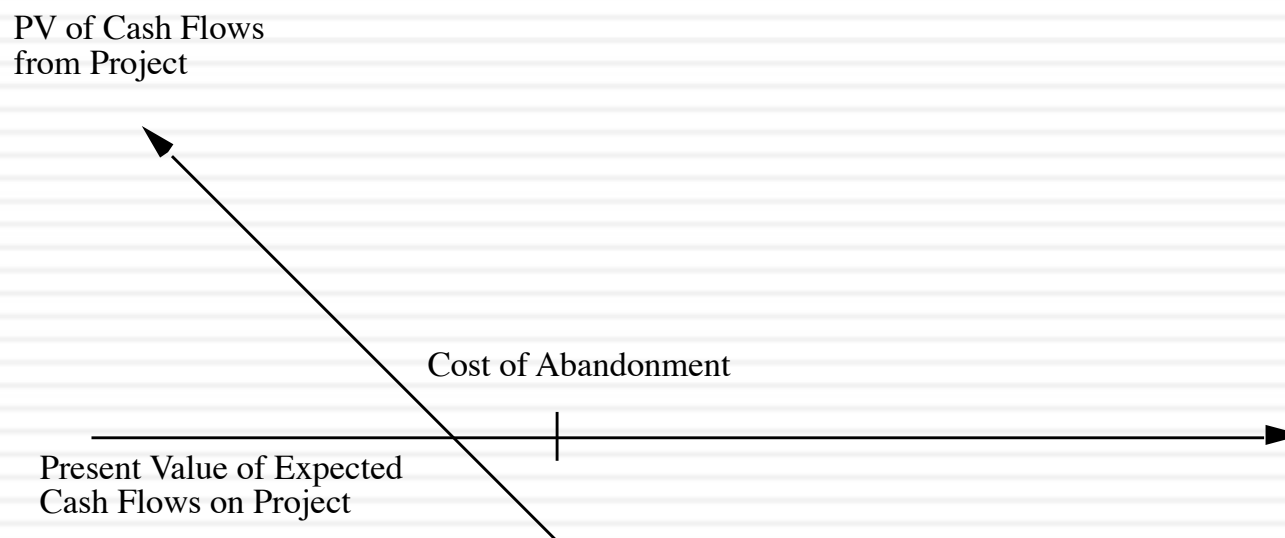
- Taking a project today may allow a firm to consider and take other valuable projects in the future. Thus, even though a project may have a negative NPV, it may be a project worth taking if the option it provides the firm (to take other projects in the future) has a more-than-compensating value.



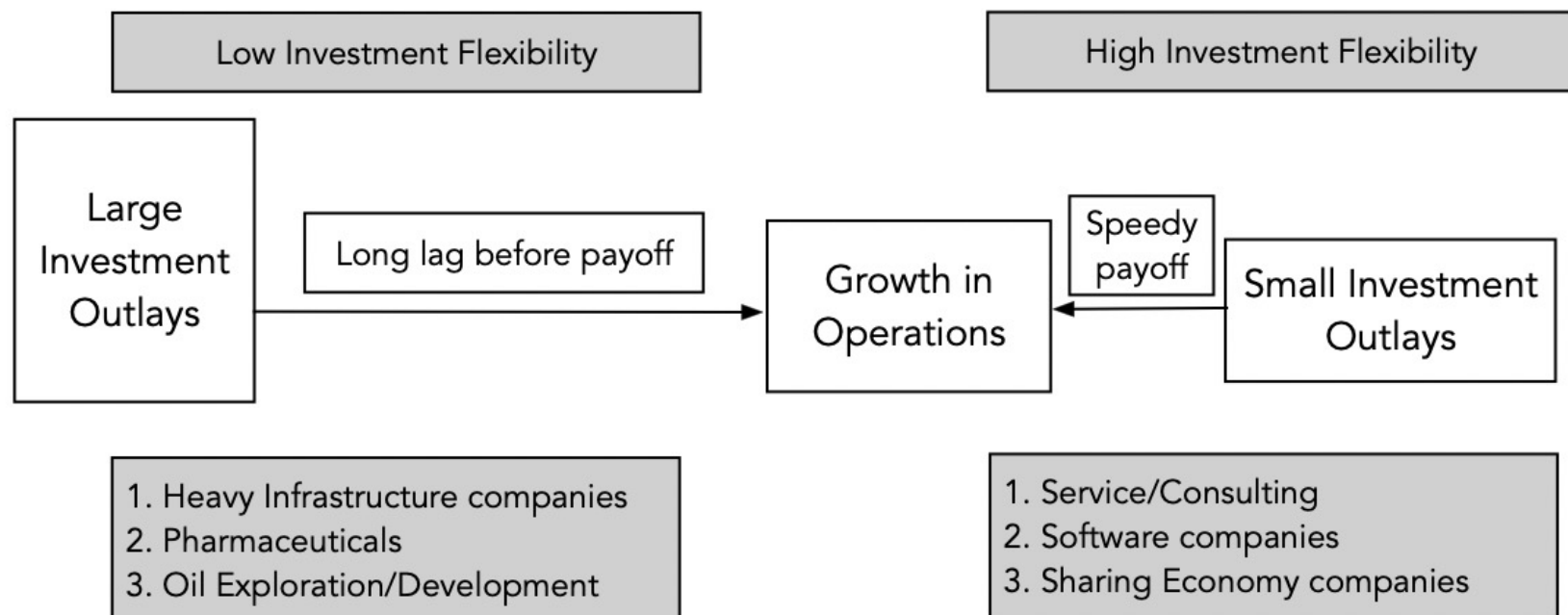
The Option to Abandon

332

- A firm may sometimes have the option to abandon a project, if the cash flows do not measure up to expectations.
- If abandoning the project allows the firm to save itself from further losses, this option can make a project more valuable.



Bottom line: Investment Flexibility matters..



And especially during crisis...

<i>Sales/Invested Capital</i>	<i>Number of firms</i>	<i>Market Cap (\$ millions)</i>			<i>Change in Market Cap (\$ millions)</i>			<i>% Change in Market Cap</i>		
		<i>2/14/20</i>	<i>3/20/20</i>	<i>6/26/20</i>	<i>2/14-3/20</i>	<i>3/20-6/26</i>	<i>2/14-6/26</i>	<i>2/14-3/20</i>	<i>3/20-6/26</i>	<i>2/14-6/26</i>
Lowest	3,411	\$ 2,523,754	\$ 1,622,667	\$ 2,049,723	\$ (901,086)	\$ 427,056	\$ (474,030)	-35.70%	26.32%	-18.78%
2nd decile	3,412	\$ 8,263,640	\$ 5,565,441	\$ 6,732,043	\$ (2,698,199)	\$ 1,166,603	\$ (1,531,597)	-32.65%	20.96%	-18.53%
3rd decile	3,412	\$ 9,811,923	\$ 6,643,479	\$ 8,244,577	\$ (3,168,444)	\$ 1,601,098	\$ (1,567,345)	-32.29%	24.10%	-15.97%
4th decile	3,411	\$11,583,438	\$ 8,280,917	\$10,379,658	\$ (3,302,521)	\$ 2,098,741	\$ (1,203,780)	-28.51%	25.34%	-10.39%
5th decile	3,412	\$10,667,397	\$ 7,693,036	\$ 9,613,456	\$ (2,974,361)	\$ 1,920,420	\$ (1,053,941)	-27.88%	24.96%	-9.88%
6th decile	3,412	\$10,826,949	\$ 7,976,816	\$10,035,911	\$ (2,850,133)	\$ 2,059,095	\$ (791,039)	-26.32%	25.81%	-7.31%
7th decile	3,411	\$ 8,417,125	\$ 5,810,221	\$ 7,680,201	\$ (2,606,904)	\$ 1,869,980	\$ (736,924)	-30.97%	32.18%	-8.76%
8th decile	3,412	\$ 6,434,071	\$ 4,547,709	\$ 5,949,052	\$ (1,886,362)	\$ 1,401,343	\$ (485,019)	-29.32%	30.81%	-7.54%
9th decile	3,412	\$11,292,626	\$ 8,300,143	\$11,516,170	\$ (2,992,483)	\$ 3,216,027	\$ 223,544	-26.50%	38.75%	1.98%
Highest	3,412	\$ 5,312,563	\$ 3,863,455	\$ 5,113,297	\$ (1,449,109)	\$ 1,249,842	\$ (199,266)	-27.28%	32.35%	-3.75%

IV. Assessing Existing or Past investments...

335

- While much of our discussion has been focused on analyzing new investments, the techniques and principles enunciated apply just as strongly to existing investments.
- With existing investments, we can try to address one of two questions:
 - ▣ Post –mortem: We can look back at existing investments and see if they have created value for the firm.
 - ▣ What next? We can also use the tools of investment analysis to see whether we should keep, expand or abandon existing investments.

Analyzing an Existing Investment

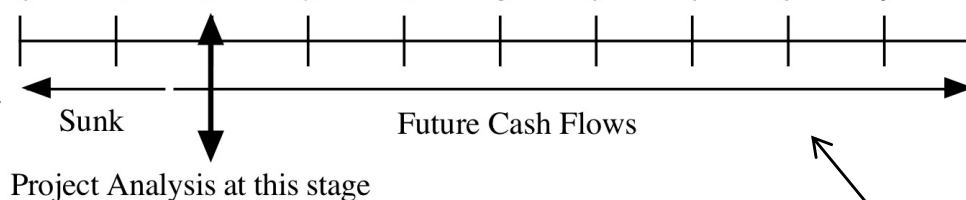
336

Figure 6.13: Analysis of Existing Project

Cashflow estimates from

New analysis: A_0 A_1 NF_0 NF_1 NF_2 NF_3 NF_4 NF_5 NF_6 NF_7 NF_8

Initial Analysis: F_0 F_1 F_2 F_3 F_4 F_5 F_6 F_7 F_8 F_9 F_{10}



F_n = Forecast of cash flows in period n in initial analysis
 A_n = Actual Cash Flow in period n
 NF_n = New forecast of cash flows in period n at end of period 2

In a post-mortem, you look at the actual cash flows, relative to forecasts.

You can also reassess your expected cash flows, based upon what you have learned, and decide whether you should expand, continue or divest (abandon) an investment

a. Post Mortem Analysis

337

- The actual cash flows from an investment can be greater than or less than originally forecast for a number of reasons but all these reasons can be categorized into two groups:
 - ▣ Chance: The nature of risk is that actual outcomes can be different from expectations. Even when forecasts are based upon the best of information, they will invariably be wrong in hindsight because of unexpected shifts in both macro (inflation, interest rates, economic growth) and micro (competitors, company) variables.
 - ▣ Bias: If the original forecasts were biased, the actual numbers will be different from expectations. The evidence on capital budgeting is that managers tend to be over-optimistic about cash flows and the bias is worse with over-confident managers.
- While it is impossible to tell on an individual project whether chance or bias is to blame, there is a way to tell across projects and across time. If chance is the culprit, there should be symmetry in the errors – actuals should be about as likely to beat forecasts as they are to come under forecasts. If bias is the reason, the errors will tend to be in one direction.

b. What should we do next?

338

$$\sum_{t=0}^{t=n} \frac{NF_n}{(1+r)^n} < 0 \quad \text{.....} \quad \text{Liquidate the project}$$

$$\sum_{t=0}^{t=n} \frac{NF_n}{(1+r)^n} < \text{Salvage Value} \quad \text{.....} \quad \text{Terminate the project}$$

$$\sum_{t=0}^{t=n} \frac{NF_n}{(1+r)^n} < \text{Divestiture Value} \quad \text{.....} \quad \text{Divest the project}$$

$$\sum_{t=0}^{t=n} \frac{NF_n}{(1+r)^n} > 0 > \text{Divestiture Value} \quad \text{.....} \quad \text{Continue the project}$$

Example: Disney California Adventure – The 2008 judgment call

339

- Disney opened the Disney California Adventure (DCA) Park in 2001, at a cost of \$1.5 billion, with a mix of roller coaster rides and movie nostalgia. Disney expected about 60% of its visitors to Disneyland to come across to DCA and generate about \$ 100 million in annual after-cash flows for the firm.
- By 2008, DCA had not performed up to expectations. Of the 15 million people who came to Disneyland in 2007, only 6 million visited California Adventure, and the cash flow averaged out to only \$ 50 million between 2001 and 2007.
- In early 2008, Disney faced three choices:
 - Shut down California Adventure and try to recover whatever it can of its initial investment. It is estimated that the firm recover about \$ 500 million of its investment.
 - Continue with the status quo, recognizing that future cash flows will be closer to the actual values (\$ 50 million) than the original projections.
 - Invest about \$ 600 million to expand and modify the park, with the intent of increasing the number of attractions for families with children, is expected to increase the percentage of Disneyland visitors who come to DCA from 40% to 60% and increase the annual after tax cash flow by 60% (from \$ 50 million to \$ 80 million) at the park.

DCA: Evaluating the alternatives...

340

- Continuing Operation: Assuming the current after-tax cash flow of \$ 50 million will continue in perpetuity, growing at the inflation rate of 2% and discounting back at the theme park cost of capital in 2008 of 6.62% yields a value for continuing with the status quo

$$\text{Value of DCA} = \frac{\text{Expected Cash Flow next year}}{(\text{Cost of capital} - g)} = \frac{50(1.02)}{(.0662 - .02)} = \$1.103 \text{ billion}$$

- Abandonment: Abandoning this investment currently would allow Disney to recover only \$ 500 million of its original investment.

$$\text{Abandonment value of DCA} = \$ 500 \text{ million}$$

- Expansion: The up-front cost of \$ 600 million will lead to more visitors in the park and an increase in the existing cash flows from \$ 50 to \$ 80 million.

$$\text{Value of CF from expansion} = \frac{\text{Increase in CF next year}}{(\text{Cost of capital} - g)} = \frac{30(1.02)}{(.0662 - .02)} = \$662 \text{ million}$$

First Principles

341

