Sources of Value: Ensuring Positive NPVs in Corporate Finance

This lecture explores how to ensure that investment projects truly have positive NPVs, recognizing the inherent biases and uncertainties in financial forecasting. It emphasizes the importance of competitive advantage and how to identify projects that truly add value.

Behavioral Biases in Investment Decisions

- **Overconfidence Bias:** People often overestimate the certainty of their forecasts, leading to an underestimation of project risks.
- **Optimism Bias:** Project sponsors may have an overly optimistic view of cash flows, especially when seeking approval.

Avoiding Forecasting Errors

- **Market Values:** Use market prices as a starting point for valuation. If an asset's market price reflects its true worth, why would your company earn more from it than others?
- **Competitive Advantage:** Positive NPVs arise from competitive advantages that allow a company to earn more than the cost of capital.
    - **Examples of competitive advantages:** Better products, lower costs, protected markets, patents, skilled employees, strong customer relationships, brand recognition, etc.
- **Long-Term Sustainability:** Consider how long your competitive advantage will last and how rivals might react.

The Value of Competitive Advantage

- **Economic Rent:** The difference between a project's economic income and the cost of capital. Positive NPV projects earn economic rents.
- **Erosion of Economic Rents:** Competition erodes economic rents, driving them towards zero.
- **Identifying True NPV:** Probe behind cash flow estimates to identify the source of economic rents and how long they will persist.

Example: Marvin Enterprises & Gargle Blasters

This case study illustrates how to analyze investment decisions in the presence of technological innovation and competition.

- **Marvin's Dilemma:** Marvin Enterprises faces the decision of whether to invest in new technology that could increase market share but also drive down prices and erode the value of existing plants.
- **Analysis:**
    - Marvin needs to forecast how prices will react to increased capacity.
    - Consider the potential impact of the new technology on the value of existing assets (cannibalization).
    - Calculate the total NPV, factoring in both the new plant and the impact on

existing assets.

- **Key Takeaways:**
    - The time it takes for competition to erode a competitive advantage is crucial.
    - Investments in high-tech industries are particularly susceptible to technological obsolescence.
    - The salvage value of existing assets influences the competitive landscape and project valuation.

Conclusion:

This lecture emphasizes the critical role of competitive advantage in achieving positive NPVs. By acknowledging behavioral biases, utilizing market data, and thoroughly analyzing the impact of competitive dynamics, companies can make informed investment decisions that truly create value.