

HOW TO SPEND MONEY (CAPITAL BUDGETING TOOLS)

Sensitivity analysis

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THE MAIN CAPITAL BUDGETING TOOLS

1. NPV
2. IRR
3. Accounting Ratios
4. Payback

CASH FLOW FORECASTING

- ▶ Everything depends on forecasts
- ▶ All forecasts are wrong!
- ▶ How sensitive are our decisions?
- ▶ What are the main value drivers?

SCENARIO ANALYSIS

Time	Cash Flows (Expected)
0	-\$5,000
1	\$3,200
2	\$2,500
3	\$1,200
4	\$1,200
5	\$1,200
NPV (@15%)	\$1,745

SCENARIO ANALYSIS

Time	Cash Flows		
	(Pessimistic)	(Expected)	(Optimistic)
0	-\$6,000	-\$5,000	-\$5,000
1	\$2,500	\$3,200	\$4,000
2	\$2,000	\$2,500	\$3,000
3	\$1,000	\$1,200	\$2,000
4	\$1,000	\$1,200	\$1,500
5	\$1,000	\$1,200	\$1,500
NPV (@15%)	-\$587	\$1,745	\$3,665

SENSITIVITY ANALYSIS

- ▶ Expand scenarios
- ▶ Calculate sensitivities
- ▶ Spreadsheets make this easy

SENSITIVITY ANALYSIS: WRAP UP

- ▶ Assumptions matter
- ▶ Forecasting is an art
- ▶ There is no 100% right answer
- ▶ Understand the limitations
- ▶ Good diagnostic tool