

HOW TO SPEND MONEY (CAPITAL BUDGETING TOOLS)

Net Present Value

James P. Weston

Professor of Finance

The Jones School, Rice University

NET PRESENT VALUE (NPV)

Add up the PV of all future cash

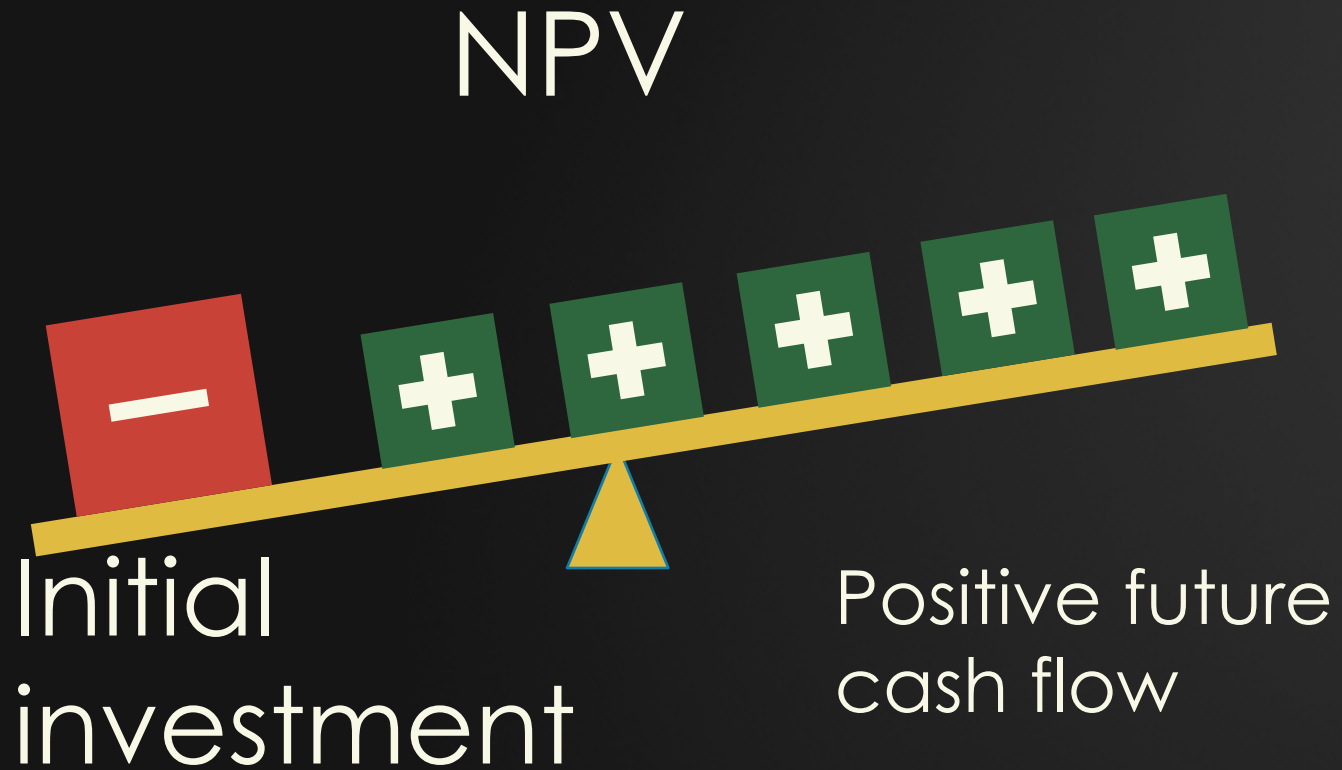
Compare with initial investment

Decision rule: Invest if $NPV > 0$

NET PRESENT VALUE (NPV)

NPV formula:

NET PRESENT VALUE (NPV)



NET PRESENT VALUE

Problem: Analyze the table of cash flows and compute the NPV if the discount rate is 10%?

Period	Cash Flow		Present Value
0	-\$1,500	→	-\$1,500
1	\$900		\$818.18
2	\$750		\$619.83
Total	\$150		-\$61.98

NET PRESENT VALUE: MAIN DRIVERS

- ▶ Cash flow (more is better!)
- ▶ Timing (the sooner the better)
- ▶ Discount rate (lower the better)

NET PRESENT VALUE: WRAP-UP

- ▶ Best capital budgeting tool
- ▶ Incorporates:
 - ▶ Timing
 - ▶ Opportunity cost
 - ▶ Risk
- ▶ Objective
- ▶ Arms-length
- ▶ Transparent