***Sneakers vs. Persistence***

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***Sneakers 2013***

In conducting our cash flow projection, building a new factory, cannibalization of sales, changes in current assets/liabilities, taxes, COGS, and advertising costs are all included in the analysis. These variables are actual expenditures and impact the amount of cash a firm will have to pay out. However, R&D costs, depreciation costs, and interest costs are not included. R&D is a sunk cost, depreciation is a non-cash account, and interest costs are incorporated in the WACC formula.

Sneaker 2013 has an initial project outlay of -$160 million. The project’s annual net cash flows (in millions) are $9.9, $36.79, $36.41, $54.18, $38.95, and $128.07 for years 2013 through 2018 respectively. Sneaker 2013 has a terminal net cash flow of $128.07 million due to the salvage value of the building and equipment. Sneaker 2013 seems viable, with a positive NPV of $32.7 million, IRR of 16.05%, and a payback period of 4.069 years.

***Persistence***

The initial investment, revenue, variable costs, fixed costs, general administrative costs, ads and promotions costs, change in net working capital, and salvage value should be incorporated into the Persistence shoe line’s forecast. These costs and revenues are all included in the forecast because they are inflows/outflows of cash and affect the company’s free cash flow. Depreciation is excluded from the Persistence forecast as it is not a cash flow.

The project’s initial outlay is $98 million due to the purchase of manufacturing equipment and the design technology/specifications. The project has annual net cash flows (in millions) of $13.51, $21.35, $4.05, $13.51, $21.35, $58.05 for years 2013 through 2018 respectively. The Persistence project has a terminal net cash flow of $58.05 million due to the change in net working capital and salvage value.

From a quantitative standpoint, Persistence does not look all that attractive. The payback period is 5.28 years which is nearly the entire length of the project. The project had a net present value of -$29,453,750. The project does not look very attractive based on this number. Despite the negative NPV, the project has an internal rate of return of 7.21%. This is significantly lower than the cost of capital (14%) signaling against investing in the project.

***Conclusions***

Persistence is clearly a riskier project as it has a negative NPV while Sneaker 2013’s is positive. This suggests that Persistence would have to strongly outperform its cash flow projection to be a worthwhile investment, while Sneaker 2013 would only need to meet the forecast. Further, Persistence is a much more niche market in which New Balance has less experience relative to Sneaker 2013.

The payback period, NPV, and IRR are 4.069 years, $32,700,683.63, and 16.05% for the Sneaker 2013 Project and -$29,453,750.45, and 7.21% for Project Persistence, which doesn’t payback at all. Based on these calculations, Sneaker 2013 beats Persistence by every metric. This suggests that if our forecasts are met, Sneaker 2013 would return more to shareholders at a faster rate. It is possible for Persistence to have a negative NPV and a positive IRR because the IRR of 7.21% is still less than the project cost of capital, which is 14%.

Rodrigues should be more critical of Project Persistence’s forecasts. As stated above, the hiking shoe market segment is a smaller category that New Balance has less experience in. Their design is outsourced, meaning that it isn’t an being made by in-house R&D. Since the design team isn’t capable of making the hiking shoe, it is reasonable to believe that the financial forecasts are not as accurate as those for Project 2013. New Balance has a long history of making competitive running shoes, so the finance department will have more experience in forecasting that kind of sneaker.

Our final recommendation is to pursue the Sneaker 2013 project over Persistence. Even if the projects were not mutually exclusive, we would still have the same suggestion. Persistence’s negative NPV suggests that it will not be a profitable endeavor. Further, Persistence’s IRR which is less than the project’s cost of capital suggests a negative return. Contrarily, Project 2013 shows a strong NPV and IRR, as well as a shorter payback period than Persistence. Therefore, Project 2013 will return more money to shareholders at a quicker rate than Persistence.

Grade 30/40

Report: well written and formatted. I would include a summary table with the main results.

Sneakers:

- Initial investment is incorrect. Equipment and installation costs are missing.

- Incorrect use of depreciation. Did not deduct it from EBIT, then added back 40% of it...?

- NWC calculations missing for 2014 onwards.

Persistence:

- Did not expense asset as instructed. This has an effect on initial investment and depreciation.

Roberto Stein , Jan 28 at 3:50pm