Aalto University
School of Business

Capital Budgeting (22E12000)

Introduction to Capital Budgeting

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Agenda

- Key concepts
- Types of capital expenditures
- The capital budgeting process
- Corporate strategy and investment decisions
- Corporate governance and investment decisions

Key Concepts

- Capital Budgeting (CB)
  - Decisions about long-term investments and the allocation of resources
  - Ultimate aim to maximize the market value of the firm’s common stock and, hence, the wealth of its shareholders (based on finance theory).
- Capital expenditure
  - Any cash outlay expected to generate cash flows lasting longer than a year

Types of Capital Expenditures

- Replacement investments
  - Can also be new technology or alternative solutions
- Expansion investments
  - Investments in new products and/or geographical markets
- Investments mandated by law
  - Environmental & safety

- Also other typifications potential: PP&E (property, plant & equipment) IT, R&D, and Mergers and Acquisitions

Project Interactions

- Independent projects
- Mutually exclusive projects
  - “We can select only A or B project, not both”
- Contingent projects
  - “We can not do just Project A without taking simultaneously Project B.”
  - Should be treated as one project

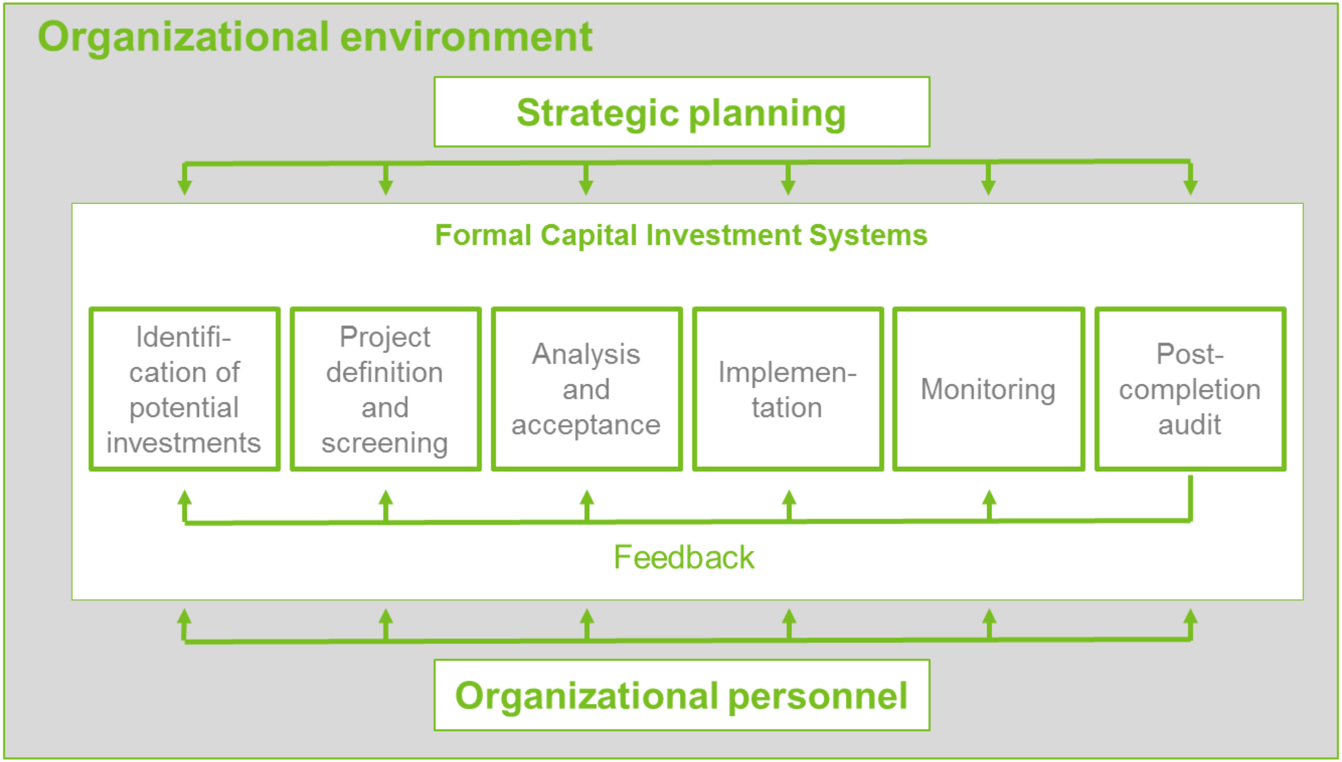
The Capital Budgeting Process
(Bhimani et al., 2008)

1. Identification Stage – determine which types of capital investments are necessary to accomplish organizational objectives and strategies
2. Search Stage – explore alternative capital investments that will achieve organization objectives
3. Information-Acquisition Stage – consider the expected costs and benefits of alternative capital investments

The Capital Budgeting Process
(Bhimani et al., 2008)

4. Selection Stage – choose projects for implementation
5. Financing Stage – obtain project financing
6. Implementation and Control Stage – get projects under way and monitor their performance (also Post-Completion Auditing)

The Capital Budgeting Process (Northcott, 1992)



Corporate Strategy and Investment Decisions (Course book chapter 2)

- Capital investment decisions are greatly embedded in a firm's strategy – they do not occur in a vacuum
- Success in CAPBUD greatly affects the extent to which a firm can achieve its targets
- Corporate strategy vs. Business unit strategy
- Corporate strategy: How to allocate resources between different businesses?
- Business strategy: How the businesses cope with competitors?

Corporate Governance and Investment Decisions (1/2) (Course book chapter 3)

- Distortions: managers try to maximise the wealth of themselves, not the wealth of shareholders
- Distortions may occur as overinvestment, underinvestment & sub-optimal risk taking
- Two kinds of information asymmetries may influence:

  (1) Information asymmetry between managers and capital markets (equity & debt)

  – Managers are better informed than capital providers
  – → scepticism about the projects → premium → underinvestment (passing up positive NPV projects)

Corporate Governance and Investment Decisions (2/2)

(2) Information asymmetry between managers and owners

- Empire-building (due to power, status) → Overinvestment?
- Compensation/career
  - Larger unit, larger incentives → Overinvestment?
  - Short-term focus → Underinvestment?
  - Herding (following the investment decisions of others) → Overinvestment, underinvestment or biased investment?
- Managerial laziness → Underinvestment?
- Overconfidence bias (managers are inherently optimistic) → Overinvestment?