**EFFECTIVE FINANCIAL MANAGEMENT**

**Learning Outcome 5: ACTIVITY 6**

**Modifications to the net present value technique**

#### The NPV technique of investment appraisal that has been introduced in this chapter was based on cash flows. Sometimes, the identification and calculation of cash flows is not straightforward.

Road Toll Ltd has been offered the chance to bid to operate a new toll road that connects mainland India to a nearby island. You will return to this case study later in the module. Some of the terms in the case study may be unfamiliar at this stage. For now, consider the data in the context of sensitivity analysis.

The company has undertaken significant analysis of the likely level of demand over the next three years. The company has asked you as the Finance Manager to undertake further investment appraisal of the project to help it create the right kind of bid proposal. The following information is available.

The company has debt which costs 11% and its estimated equity cost of capital is 15%, it is geared 50:50.

The cost of the toll for using the road has been extensively researched and the marketing department has arrived at a fee of $10 per vehicle, per journey as acceptable to motorists.

The Finance team has estimated that running the toll service will cost $1,200,000 per annum.

The contract is for three years and the likely acceptable bid price for exclusive rights to operate the toll road is $1,000,000. All fixtures and fittings required to operate the toll road are included in this price, as is ongoing maintenance of the road and the toll facilities.

The analysis so far has predicted the following demand levels:

Estimated Demand

Year 1 2 3

Number of journeys 150,000 185,000 350,000

These could vary by as much as ten percent i.e. they could be 10% higher or 10% lower than this estimate.

 The company has a hurdle payback period of two years, a companywide average return on investment of 25%.

So far the company has invested $100,000 in research and administration.

#### In small groups

In addition to considering the case above as you answer the questions below, you should also identify a business with which you are familiar. This could be a multinational company from which you have purchased goods/services, a business that owns your favourite brand or the business for which you work (or wish to work in the future).

Ideally this should be the business you chose earlier to re-visit throughout your classroom activities.

From your research:

1. Identify the factors that might need to be considered when applying the net present value technique.
2. Reflect on the circumstances of the Road Toll Ltd case and the nature of the NPV technique. Consider if any of the factors that might lead to a need for modification apply.
3. Consider your chosen business and the factors that you identified in (1). Explain which of the factors might apply to your chosen business. Justify your explanation.
4. Prepare a short presentation on your findings.