



Making Critical Investment Decisions

Building greater value for your company hinges on allocating scarce capital resources prudently.

by Mark D. Working

The economic storm of the past several years will soon end. Many think it already has. As the economy regains vigor, new opportunities will present themselves. The ability to select the right opportunities and build greater value will hinge on decisions about how to prudently employ the company's capital resources.

Possibly the most important resource decision a company makes is the allocation of its capital, a scarce resource for most companies. Capital must be allocated to the best opportunities—those that will yield superior returns. The criteria for capital investments must be more sophisticated than whether a profit can be earned and whether the bank will fund it. The appropriate analysis must take into account all of the investment's costs, the net cash flows generated by the investment, and the rate of return on the capital used to fund it.

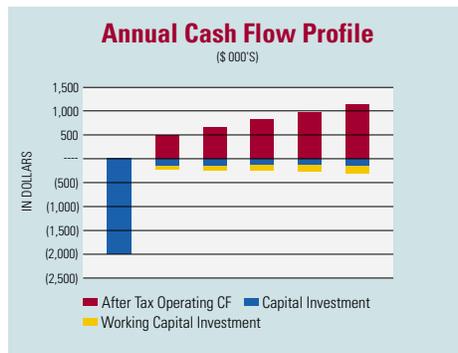
ELEMENTS OF INVESTMENT ANALYSIS

The objective of investment analysis, or capital budgeting, is to gauge the likelihood that the return earned from the investment will be sufficient to justify the project. There must be a reasonable expectation of returns at least equal to, if not greater than, the company's cost of capital. Anything less and shareholders lose value. Anything more creates shareholder value. The elements necessary to complete the analysis are:

- The capital to buy or build the equipment and facility, hire and train the people, carry the inventory and receivables, and otherwise launch the investment.
- The incremental free cash flow generated from the business opportunity after considering the operating profits (sales, less cost of sales, less marginal operating expenses), reduced by the marginal tax obligations and the ongoing requirements for working- and fixed-capital expenditures.

Mapping these two elements generates a profile that shows the initial outflow of the capital investment and the return of that capital over time.

The analysis must be forward looking, not



retrospective. So, although the main planning assumptions may be easily identified, the calibration of those assumptions can be extraordinarily challenging. How much capital will be needed? How much cash flow will be generated? What is the timing of the cash flows? How predictable will it be? The analysis tends to be an iterative process of sorting through a complex web of dependent

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and independent variables to reach reasonable conclusions about the investment's key elements. Rarely is there a single right answer; instead, there is a range of potential outcomes based on the interaction of all of the variables.

Having modeled the expected cash flows, the third factor central to the investment analysis is applying the appropriate after-tax weighted average cost of capital (WACC). Much argument can occur over what the proper rate should be. It is commonly estimated as the weighted average of the cost of equity (25% to 30% in most privately held, middle-market businesses) and the after-tax cost of debt (3.5% to 4.0% in the current

interest rate environment). The weighting is often a judgment based on the optimal capital structure for the industry. An equally-weighted capital structure of debt and equity would imply a WACC of approximately 16% per annum.

The value of the investment is determined by discounting the free cash flows in each future period by the WACC and then subtracting the initial capital outlay. To the extent that the result is a positive number, value is created and the investment is beneficial. If the result is negative, the investment detracts from the company's value.

AN INVESTMENT EXAMPLE

A major customer approached Sea Tac Corp. with an opportunity to expand its business by supplying widgets at an attractive price. In fact, the customer would commit to buy a certain volume of widgets from Sea Tac over the next five years. With this added volume, Sea Tac would be able to increase sales at a higher profit margin than has been earned from its existing customers. The company would need to expand capacity to manufacture the additional volume.

The company's bank reviewed the revised financial projections and agreed to underwrite the plant expansion with a five-year-term loan commitment. Given the low leverage on the business and the fact that the expansion represented only a small incremental change to the overall business, the approval by the company's bank did not require a detailed analysis of the business opportunity.

Recognizing that the bank's credit analysis is different from an investment analysis, Sea Tac's CEO asked two financial advisors to evaluate the investment. The first advisor mapped out the expected consolidated cash flow and, using the company's WACC of 16%, determined that the project was slightly positive, confirming that the project was justified.

The second advisor considered the opportunity differently. This advisor also concluded that the new business was desirable, but questioned whether the investment in the new capacity created value. The thinking was that because the existing capacity was

Advisors' Analyses

	Advisor 1	Advisor 2
Initial Investment	(2,000)	(2,000)
Annual Capex	(100)	(100)
After-Tax Cash Flows		
Year 1	428	330
Year 2	570	440
Year 3	713	550
Year 4	855	660
Year 5	998	770
Net Present Value	12	(527)
Investment Justified?	Yes	No

suitable for the production of all widgets, the added capacity could be considered as being built to service the company's lowest margin customers. The second advisor conducted the analysis in the same manner as the first advisor, except it used the company's margins on its current customers rather than the higher margin expected from the new business.

This analysis led to the conclusion that building new capacity was not justified by the cash flow earned from the lowest-margin customers. The implication was that the current business should be repriced at higher margins

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to justify the new facility, or else the existing plant capacity should be used to service the new business in lieu of the lowest-margin ex-

isting customers. In other words, although the new business would add value, the investment in a new facility would not.

EVERYDAY INVESTMENT DECISIONS

Every time you open the door, flip on the lights, crank up the plant, take an order, or leave a dollar of retained earnings in the business, you are making an investment decision. Investment analysis is a discipline that is useful for analyzing all elements of the business (customers, product lines, plants, equipment, marketing campaigns, training, etc.), whether existing or potential additions. The purpose is to guide the allocation of capital so it is employed wisely in a manner that will generate an appropriate return for the risks taken. Corporate value will be enhanced if an investment mind-set is ingrained into the organization's culture. With an improving economy and new opportunities arising, wise capital decisions made now could make a meaningful difference in future value. ❖



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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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