ADVANCED CAPITAL BUDGETING DECISIONS

CLASS 7-HW-Q16

Topic Risk Adjusted Discount Rate (RADR)

Question 16:

A pencil manufacturing company is considering the introduction of a line of gel pen with an expected life of five years. In the past the firm has been quite conservative in its investment in new projects, sticking primarily to standard pencils. In this context, the introduction of a line of gel pen is considered an abnormal risky project. The CEO of the company is of opinion that the normal required rate of return for the company of 12% is not sufficient. Therefore, the minimum acceptable rate of return of this project should be 18%. The initial outlay of the project is ₹ 10,00,000 and the expected free cash flows from the projects are given below:

Year	Cash Flow
1	₹ 2,00,000
2	₹ 3,00,000
3	₹ 4,00,000
4	₹ 3,00,000
5	₹ 2,00,000

(Source: ICAI)

ANSWER:

NPV = $2{,}00{,}000/(1.18) + 3{,}00{,}000/(1.18)^2 + 4{,}00{,}000/(1.18)^3 + 3{,}00{,}000/(1.18)^4 + 2{,}00{,}000/(1.18)^5$ – 10,00,000 = (–) ₹ 1,29,442

Project not feasible.