Facilitating Expansion Decisions
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Introduction

Businesses continuously have to make important investment decisions relating to the question of whether they should invest in new projects or other expansion opportunities with the aim to grow the business. These investments generally require a large capital commitment upfront (in the form of the acquisition of various assets such as plant and/or equipment) that will consequently tie up available capital for a period of time. The correct decisions are thus crucial to the long-term growth potential of any business.

Analysis of Potential Expansion Projects

Long-term investment proposals should be analysed and selected based on sound capital budgeting and capital investment principles.

Listed below are the core principles and steps that would help any business in their decision-making process:

- All medium and long term investment proposals should be consistent with the business's strategic goals (linked to its mission, vision and objectives). A business should continuously review its strategic objectives through a logical strategic planning process with all potential investments reviewed on a relative basis for their consistency with the defined strategy of the business.
- The financing cost of the "money" or capital that will be invested in a project should be taken into account when evaluating a potential investment. The lower the cost, the higher the net return on any investment. The cost of capital can be calculated as a weighted average of the cost of all sources of financing, be it either from equity or debt based instruments. It is advisable that a business work with a target Weighted Average Cost of Capital (WACC) based on its optimal capital structure, meaning the optimal mix of equity (shareholder funds) and debt financing, where the "average" cost of financing is the lowest from the business's point of view. *Practically a business would then also strive to at all times finance its assets at the optimal mix.* The WACC is thus the minimum required return of any project.
- Estimates, projections and forecasts of the potential future cash flows that are a direct result of the project under review should be calculated/ determined.
    - The focus should be on the after tax cash flows and not on accounting profit,
    - The life of the potential project should be taken into account,
    - The period in which the cash flows are expected to be generated should be clearly recognised,
    - Adjustments for inflation and potential extraordinary risks should be taken into account.

- The cash flows would then be discounted at the Weighted Average Cost of Capital in order to calculate the present value of the cash flow streams that are projected to be generated by any potential project. A potential project will be analysed at a specific point in time, thus the information relating to a project should be relevant to that point in time, hence future cash flows are discounted to their present values.

- Adding together the relevant present values of future cash flows and subtracting the upfront capital outlay will calculate the Net Present Value (NPV) of the project. If this Net Present Value is positive, it means at the point in time the analysis is completed, taking into account the target financing costs of a business, the project will generate value that is higher than the finance cost, and consequently such projects should be accepted.

The Net Present Value technique, highlighted above, is one of the most commonly used project appraisal techniques in industry.

Other project appraisal techniques include:

- Payback Period (time it takes to recoup initial investment),
- Discounted Payback Period (same as Payback Period, except that cash flows are discounted before the Payback Period is calculated)
- Internal Rate of Return (the IRR indicates the compound annual rate of return on a project, given its up-front investment and subsequent cash flows)

Conclusion

Potential investment proposals should be analysed and selected based on sound capital budgeting and capital investment principles and techniques. The Net Present Value (NPV) techniques is one of the techniques that will lead businesses to make the correct decisions when resources are allocated to potential projects, cognisant that the projects are in line with the strategic objectives of a business.

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