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REAL OPTIONS IN CAPITAL BUDGETING

Capital projects are taken up for evaluation based on variety of assumptions. Some of the assumptions are more theoretical and lacking practical application. If those theoretical assumptions are replaced with practical scenarios, then evaluation will be sound and appealing. Considering such practical aspects in evaluating capital budgeting decisions is referred to as Real Options in capital budgeting. They are (i) Timing option (ii) Abandonment option and (iii) Expansion and New Product option

The Timing Option:

Many projects can be started now or some time in future. The fact that the project has a positive net present value does not necessarily imply that now is the best time to initiate the project. Valuing the timing option is simple when there is no uncertainty. One can calculate the project's NPV at various dates of project commencement and pick the one date with the highest NPV. Of course, this will not work when there is uncertainty.It is the question of when to take off i.e. now or an year later.

Abandonment Option:

Some projects can be abandoned any time during the period of the project. The scope of abandonment for a price would enhance the value of the project rather than evaluating project that it should compulsorily be carried out through the term. Abandonment comes in the form of some buyers showing interest in taking up the project during the term for the remainder period of the term. Evaluating the project with abandonment option is also part of capital budgeting study.

Expansion Option:

Projects can also contain an option to expand into a new geographical market. For example, many companies currently are investing in Eastern Europe, Russia, and China in projects that appear to have negative NPVs. However, if customers in those developing markets like the new products or services, then the option to open more facilities could be quite valuable.

New Product Options can also be a valuable. For example, a company might accept a negative NPV project if it has embedded in it the option to add complementary projects, or successive "generations" of the original product. For example, Toshiba probably lost money on its first laptop computers, but the manufacturing skills and consumer recognition it gained helped turn its subsequent generations of laptops into money makers. In addition, Toshiba used its experience and name recognition in laptops as a springboard into the field of desktop computers.

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