

- Profitability Index – Measures the NPV per \$ of investment.
 $PI = \text{NPV Project} / \text{initial investment}$.

Investment Appraisal Techniques Compared:

NPV:

- PV of inflows minus PV of outflows
- Investment Rule – Accept if NPV positive, for mutually exclusive choose where NPV is highest.
- Consistent with maximising value of firm and properly chooses amongst mutually exclusive investments, but falls against capital rationing.

IRR:

- Discount rate at which NPV is zero
- IR - Accept if IRR is greater than opportunity cost of capital.
- Falls against mutually exclusive projects.

Payback Period:

- Time until the sum of project cash flows equals the initial investment.
- IR - Accept the project if the payback period is less than some specified number of years.
- Improperly rejects long term projects and ignores cash flows beyond acceptable payback period.

Profitability index:

- ❖ Ratio of NPV to value of initial investment
- ❖ IR - Accept if Profitability Index is greater than zero, accept with capital rationing, where projects constrained give highest PI, they should be chosen.
- ❖ Can rank mutually exclusive projects.

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- 5) What would happen if on the date the investor wanted to purchase the share, the share price was \$45?

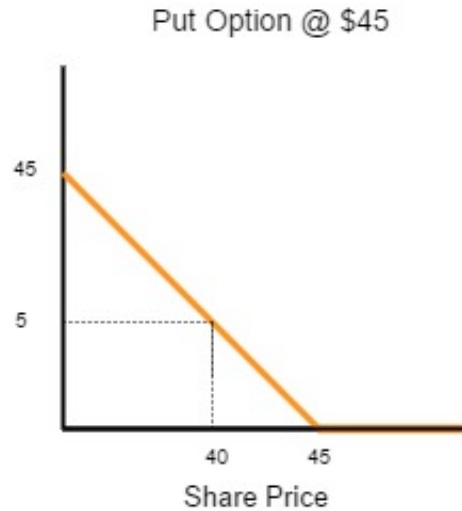
It doesn't matter if the investor exercises the put option or sells the share on the stock market as either way, it will generate funds of \$45. The option would be classed as **AT THE MONEY**.

→ For a put option:

- In the money if the share price is less than the strike price as in 3) then the option has Intrinsic Value.

INTRINSIC VALUE PUT OPTION = STRIKE PRICE – SHARE PRICE = \$45 - \$40 = \$5.

- At the money or out of the money: if the share price is greater than or equal to the strike price, as in 4) or 5), then the option has no intrinsic value. An option can never have negative intrinsic value.,



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