Solution.

Cost of equity capital $(r_e) = r_f + \beta\ (r_m - r_f)$

where r_f = is risk-free return. This is equal to 9%

r_m = is the return on the average stock on the market as a whole which is equal to 12 per cent

β = 0.8

Substituting these values in the CAPM model, we have

$$r_e = 9 + 0.8\ (12 - 9)$$
$$= 9 + 2.4 = 11.4\%$$

QUESTIONS FOR REVIEW

1. What is meant by cost of capital ? Mention the two important components of the overall cost of capital.
2. Distinguish between cost of debt capital and cost of equity capital. Why is debt capital usually cheaper than equity capital ?
3. How do you expect the cost of capital will change ?
   (*i*) If market rate of interest rises.
   (*ii*) If the firm changes its capital structure by raising the proportion of debt capital.
   (*iii*) If the marginal rate of tax on the income of the companies is raised.
4. Debt capital is usually cheaper than equity capital. Why then the firms do not exclusively rely on debt financing of their investment projects ?
5. Why are Government securities taken to be risk-free ? What is used as risk-free rate ?
6. What additional risks do the shareholders of a firm face in comparison with the holders of Government securities ?
7. Why do different firms choose different debt-equity ratio ?
8. What is the relationship between the firm's net cost of debt capital with marginal income tax rate ?
9. Why do firms have substantially different capital structure ? Why do firms in the public utility undertakings have generally higher debt component in their capital structure ?
10. What is meant by composite cost of capital ? What are its two constituents ?

NUMERICAL PROBLEMS

Problem 1. *Manager of Ravindra Printers finds that initial investment (i.e., initial cost of buying a new printing machine is Rs 10,00,000. The machine will be depreciated in five years with salvage value of zero. He also estimates that increment in revenue or income from the new machine will be Rs 8,00,000 per year. The increase in costs as a result of using new machine on account of use of direct labour and materials, transportation, additional overhead charges, building rent associated with the new machine would amount to Rs 4,50,000 per year. Marginal income tax for the firms is 40 per cent.*

Based on the above information :

(*a*) *Calculate the Net Cash Flow (NCF) using straight line method of depreciation.*

(*b*) *Using Internal Rate of Return method (IRR) method, should the new investment project be accepted or rejected if the cost of capital happens to be 12 per cent per annum.*

Solution.

(*a*) NCF = Net Income before Tax – Income Tax + Depreciation

Therefore, to calculate Net Cash Flow (NCF), we have to calculate Net Income before Tax, Income Tax and Depreciation.

Net Income before Tax = Annual Income (or Revenue) – Incremental Costs – Depreciation

Annual Income or Revenue = Rs 8,00,000

Incremental Costs = Rs 4,50,000

Depreciation at the rate of 20% (straight line method) as the machine's life is 5 years

$$= 10{,}00{,}000 \times \frac{20}{100} = 2{,}00{,}000$$

Net Income before Tax = 8,00,000 – 4,50,000 – 2,00,000

= Rs 1,50,000

$$\text{Income Tax} = 1{,}50{,}000 \times \frac{40}{100} = 60{,}000$$

Net Cash Flow (NCF) = Net Income before Tax – Income Tax + Depreciation

= 1,50,000 – 60,000 + 2,00,000

= Rs 2,90,000

(*b*) **Rate of Return : IRR Method**

According to IRR method, rate of return is the discount rate at which present value of cash flow will be equal to initial cost of investment.

Thus,

$$* \sum_{t=1}^{5} \frac{2{,}90{,}000}{(1+r)^t} = \frac{2{,}90{,}000}{1+r} + \frac{2{,}90{,}000}{(1+r)^2} + \frac{2{,}90{,}000}{(1+r)^3} + \frac{2{,}90{,}000}{(1+r)^4} + \frac{2{,}90{,}000}{(1+r)^5}$$

$$= 2{,}90{,}000\left[\frac{1}{1+r} + \frac{1}{(1+r)^2} + \frac{1}{(1+r)^3} + \frac{1}{(1+r)^4} + \frac{1}{(1+r)^5}\right]$$

where r is the rate of discount or return.

$$\sum_{t=1}^{n} \frac{NCF_t}{(1+r)^t} = C$$

where NCF_t is net cash flow per year, C is the initial cost of investment and r is the rate of return.

As calculated above, NCF = Rs 2,90,000

Initial Cost (C) = Rs 10,00,000

n = 5 years

Substituting these values in the formula, we have

$$\sum_{t=1}^{5} \frac{2{,}90{,}000^*}{(1+r)^t} = 10{,}00{,}000$$

or

$$\sum_{t=1}^{5} \frac{1}{(1+r)^t} = \frac{10{,}00{,}000}{2{,}90{,}000} = 3.4483$$

It should be noted that the term $\left[\sum_{t=1}^{5} \frac{1}{(1+r)^t}\right]$ represents the present value of annuity of Re 1 for five years discounted at the rate of r. In order to find out the value of r we have to use the table giving the present value of annuity of Re 1 in a future period which is generally called Present Value Interest Factor (PVIF) and is provided in the Log Book. Looking at the table giving Present Value Interest Factor on the fifth row (indicating 5 years period) it will be seen that figure of 3.4483 lies between 3.5172 and 3.4331 corresponding to 13% and 14% discount rate.[1] This means that the rate of return is greater than 13% but less than 14%. The given cost of capital is 12 per cent. This implies that rate of return is greater than the given cost of capital. Thus, undertaking of the project will add to the value of the firm and should therefore be undertaken.

(*c*) **NPV Criterion.** According to this, a capital investment project should be accepted if NPV > 0. That is, with the given cost of capital equal to 12%, for capital investment project to be undertaken.

$$NPV = \sum_{t=1}^{5} \frac{NCF_t}{(1+12)^t} - C > 0$$

As calculated above net cash flow (NCF) is Rs 2,90,000 per year for five years. Thus,

$$NPV = \sum_{t=1}^{5} \frac{2{,}90{,}000}{(1+0.12)^t} - 10{,}00{,}000$$

$$\sum_{t=1}^{5} \frac{2{,}90{,}000}{(1+0.12)^t} = 2{,}90{,}000\left[\frac{1}{(1+0.12)} + \frac{1}{(1+0.12)^2} + \frac{1}{(1+0.12)^3} + \frac{1}{(1+0.12)^4} + \frac{1}{(1+0.12)^5}\right]$$

$$= 2{,}90{,}000(3.60478)$$

$$= 10{,}45{,}386.2$$

$$NPV = 10{,}45{,}386.2 - 10{,}00{,}000$$

$$= 45{,}386.2$$

1. Exact discount rate or interest rate can be obtained through interpolation.

Thus, Net Present Value of the cash flows of the investment project is greater than zero (that is, positive). Therefore, investment in the project should be undertaken as it will increase the value of the firm or shareholders' wealth.

Problem 2. *S Chand & Co is considering a proposal for investment in a new machine for binding for which it has to incur initial cost of Rs 25 lacs. It has been estimated by the Company's manager that new binding machine will cause cost-saving in the publication of the books. Because of its cost-saving it has been estimated that it will generate additional net cash flows which are given below over its anticipated life of five years. If S Chand & Co requires return of 15 per cent on the investment project, should the investment in the new binding machine be undertaken ? Use Net Present Value criterion to evaluate the project.*

Year (NCF_t)	*Net Cash Flow*
1	*6,00,000*
2	*8,00,000*
3	*8,00,000*
4	*6,00,000*
5	*2,50,000*

Solution.

$$NPV = \sum_{t=1}^{n} \frac{NCF_t}{(1+0.15)^t} - C$$

We calculate the present value of cash flows $\left[\frac{NCF_t}{(1+0.15)^t}\right]$ in the following table.

Year (1)	*Net Cash Flow* (NCF_t) (2)	*Present Value Interest Factor at 15%* $\left(\frac{1}{(1+0.15)^t}\right)^*$ (3)	*Present Value* (PV) (2) × (3) (4)
1	6,00,000	0.86957	521,742
2	8,00,000	0.75614	604,912
3	8.00,000	0.65752	526,016
4	6,00,000	0.59175	343,050
5	2,50,000	0.49718	124,295
			Total = 2120,015

* The Present Value Interest Factor at 15% is taken from the Log Table which are provided to the students. Present Value Interest Factor implies what would be the present value of Re 1 after 1 year, after 2 years, after 3 years and so on at 15 per cent rate of interest.

Thus, $$NPV = \sum_{t=1}^{n} \frac{NCF_t}{(1+0.15)^t} - C = 2120{,}015 - 25{,}00{,}000 = -379985$$

Thus, the Net Present Value of the given investment proiect is negative and should not therefore be undertaken.

QUESTIONS FOR REVIEW

1. What is meant by capital budgeting (that is, capital investment decisions) ? Why is it of crucial importance ?

2. What general guidelines firms should follow in properly estimating the net cash flow from an investment project ?

3. What is the difference between the profit flow and net cash flow from a capital investment project ? Why do firms use the net cash flow to estimate the net present value of an investment project ?

4. Explain the nature of capital investment (*i.e.*, capital expenditure) decision ? How does it involve uncertainty ?

5. What is meant by *'state of nature'* ? What does it imply for capital investment decision ?

   (**Hints** : By state of nature we mean conditions prevailing in future which cannot be perfectly predicted. This creates *uncertain environment* in which firms have to take capital investment decisions. For details see a section in the foregoing chapter.)

6. Capital budgeting decision can make or mar the fortunes of firms. Comment.

   (**Hints** : See Introduction and Section on *'Importance of Capital Investment Decisions'* in the chapter.)

7. Compare the Net Present Value (NPV) and Internal Rate of Return (IRR) methods of evaluating investment projects. When do they provide contradictory results ? Which method should then be used ?

8. When the Net Present Value (NPV) is greater than zero, what does it imply about internal rate of return ?

9. Why do firms face capital rationing problem ? What investment criterion should the firm use when it faces capital rationing problem ?

10. What is the basic principle underlying capital investment decision (*i.e.*, capital budgeting decision) ? Show that capital budgeting is nothing more than the application of the theory of firm to investment project.

    (**Hints** : According to the theory of firm, a firm produces a rate of output at which marginal revenue equals marginal cost of production. The general principle underlying capital budgeting is the same, namely, a firm undertakes the amount of capital investment at which marginal return from capital project equals marginal cost of capital. For details see the text in the book.)

11. Why is marginal cost of capital schedule or function generally rising for most firms? Explain.

12. Which of the following are capital investment decisions ? Give reasons.

    (*i*) Replacing old machine by a new machine embodying new technology.

    (*ii*) Buying 40 per cent common stock (*i.e.*, common shares) of a new competitive firm.

    (*iii*) Employing additional staff to meet peak-season demand for a product.

    (*iv*) Engaging a security agency at the cost of Rs 5 lac per annum to guard factory premises.

    (*v*) Making a plan for intensive advertising campaign to promote the sales of a product.

    (*vi*) Making a plan for higher expenditure on R&D project.

[**Hints Ans.**

(*i*) Yes, it is a capital investment as it expands the resource or capital base of the firm.

(*ii*) Yes, it is a capital investment as it expands the capital base of the firm.

(*iii*) No. It is not a capital investment decision as it relates to the deployment of resources.

(*iv*) No. It is not a capital investment decision as it relates to the maintenance of the existing value of the firm.

(*v*) Yes, expenditure on an advertising campaign is a capital investment decision as it increases revenue of the firm and hence it profits which causes increase in the value of the firm.

(*vi*) Yes, as expenditure on Research and Development (R&D) either reduces cost or improves productivity and hence raises the value of the firm.]

13. What is the *decision rule for investment* in the following methods of project appraisal ?

    (1) Payback Period Method

    (2) NPV Method

    (3) Internal Rate of Return Method

Ans. (Hints : (1) Payback Period Method. According to payback period method, decision rule is : if payback period of an investment project is less than cutting-off cost, it should be accepted, otherwise rejected.

Regarding selection of a project among two or more projects, the decision rule in payback method is *"choose an investment project among two or more projects which has a shortest payback period"*.

(2) NPV Method. In the *Net Present Value Method, decision rule for investment is accept a project if its Net Present Value is positive (NPV > 0).* That is, when

$$\sum_{t=1}^{n} \frac{R_t}{(1+i)^t} - C > 0$$

Regarding choice among projects decision rule in NPV method is *"from the available projects, choose the project for investment which has the highest NPV"*.

(3) IRR Method. According to IRR method, *if IRR of a particular project is greater than the cost of capital, project should be undertaken.*

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एम.सी. वैश्य

विषय सूची : प्रथम भाग: मुद्रा तथा कीमतें ●मुद्रा का आविष्कार ● मुद्रा तथा अर्थव्यवस्था ●मुद्रा के प्रकार तथा कार्य ●मुद्रा के मूल्य निर्धारण का वस्तु सिद्धान्त ● मुद्रा का परिमाण सिद्धान्त ● कीमतों का आय-व्यय सिद्धान्त अथवा मुद्रा का बचत-निवेश सिद्धान्त ● कीन्स का द्रव्य तथा कीमतों का सिद्धान्त ● मिल्टन फ्रीडमैन का मुद्रा का परिमाण सिद्धान्त ● मुद्रा के मूल्य में परिवर्तनों की माप ● मुद्रा मान ● स्वर्ण मान ● कागजी अथवा प्रबन्धित मुद्रामान ● **द्वितीय भाग:** चक्रीय उच्चावचन तथा स्थिरता ● व्यापार चक्र का अर्थ तथा प्रकृति ●व्यापार चक्र के सिद्धान्त ●व्यापार चक्र का नियंत्रण ● मुद्रा स्फीति ●निवेश गुणक ●त्वरक सिद्धान्त ● मौद्रिक नीति ●मुद्रा की पूर्ति ●राजकोषीय नीति ●**तृतीय भाग:** बचत, निवेश ● ब्याज तथा रोजगार ●बचत पूर्ति ● निवेश माँग ●नकदी अधिमान ●ब्याज के सिद्धान्त ● प्राकृतिक तथा बाजार ब्याज की दरें ● रोजगार का सिद्धान्त ●**चतुर्थ भाग:** ● साख मुद्रा, बैंकिंग का विकास ●केन्द्रीय बैंक ● विदेशी विनिमय दर ● विदेशी विनिमय नियन्त्रण ●मुद्रा अवमूल्यन ●मुद्रा बाजार **पंचम भाग :** अन्तराष्ट्रीय वित्तीय संस्थाएं साख मुद्रा बैकिंग ● विदेशी विनिमय तथा अन्तर्राष्ट्रीय व्यापार ●अन्तराष्ट्रीय मुद्रा कोष ●अन्तर्राष्ट्रीय नकदी ●अन्तर्राष्ट्रीय पुनर्निर्माण एवं विकास बैंक ●अन्तर्राष्ट्रीय विकास संघ ●अन्तर्राष्ट्रीय वित्त निगम ●एशियाई विकास बैंक ● **षष्ठ भाग:** भारतीय मुद्रा तथा बैंकिंग ●भारतीय मुद्रा का इतिहास ●रिजर्व बैंक ऑफ इण्डिया ●स्टेट बैंक ऑफ इण्डिया ●बैंकों का सामाजिक नियन्त्रण तथा राष्ट्रीयकरण ●भारतीय मौद्रिक नीति ●नाम-सूची ●विषय-सूची

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आर्थिक विचारों का इतिहास

एम.सी. वैश्य

विषय सूची : प्रथम खण्ड : पूर्व-संस्थापित आर्थिक विचार ●आर्थिक विचारों के इतिहास की विषय सामग्री तथा महत्व ●प्राचीन आर्थिक विचार ●मध्यकालीन आर्थिक विचार ●वणिकवाद ●प्रकृतिवादी ●**द्वितीय खण्ड :** संस्थापित आर्थिक विचार ●संस्थपित अर्थशास्त्र तथा एडम स्मिथ के पूर्वाधिकारी ●एडम स्मिथ ●जेरेमी बेन्थम ●थोमस रोबर्ट माल्थस ●माल्थस के पश्चात् जनसंख्या सिद्धांत ●डेविड रिकार्डो ●फ्रांस तथा जर्मनी में संस्थापित अर्थशास्त्र ●रिकार्डो के पश्चात् संस्थापित अर्थशास्त्र ●जॉन स्टुअर्ट मिल ●प्रतिष्ठित अर्थशास्त्र मिल से लेकर मार्शल तक ●तृतीय-खण्ड : संस्थापित अर्थशास्त्र के आलोचक ●जीन चार्ल्स साईमोड डी सिसमोण्डी ●रोट-साइमन तथा सेंट-साइमनवादी ●राष्ट्रवादी ●फ्रैडरिक लिस्ट ●इतिहासवादी सम्प्रदाय ●चतुर्थ-खण्ड : समाजवादी सम्प्रदाय ●आर्थिक प्रणालियां ●समाजवाद का अर्थ तथा इसके प्रकार ●साहचर्य समाजवादी ●थेरी जोसफ प्रोधों ●राज्य समाजवादी ●कार्ल मार्क्स ●पंचम-खण्ड : आत्मनिष्ट सम्प्रदाय गणितीय तथा आस्ट्रियाई सम्प्रदाय नवप्रतिष्ठित सम्प्रदाय एल्फ्रेड मार्शल, स्टॉकहोम तथा कैम्ब्रिज सम्प्रदाय तथा संस्थानिक अर्थशास्त्र ●आत्मनिष्ट सम्प्रदाय अथवा सुखवादी ●गणितीय सम्प्रदाय ●आस्ट्रियाइ अथवा मनोविज्ञानी सम्प्रदाय ●नव-परम्परावाद : एल्फ्रेड मार्शल ●जॉहन गस्टाफ नट विक्सेल अथवा स्वीडिश अथवा स्टॉकहोम सम्प्रदाय ●कैम्ब्रिज सम्प्रदाय के अन्य सदस्य ●जॉन मेनार्ड कीन्स ●संस्थानिक अर्थशास्त्र ●कुछ आधुनिक अर्थशास्त्री ●षष्टम-खण्ड: भारतीय आर्थिक विचारधारा ●प्राचीन भारत में आर्थिक विचार ●भारतीय अर्थशास्त्र के संस्थापक ●गांधीजी के आर्थिक विचार ●जवाहरलाल नेहरू के आर्थिक विचार ●जे.के. मेहता के आर्थिक विचार ●नाम सूची ●विषय सूची

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आर्थिक विकास एवं नियोजन

एस.पी.सिंह

विषय सूची : खण्ड-(अ): आर्थक विकास के सिद्धान्त **खण्ड-ब :** विकास-नियोजन के कुछ अन्य पहलू **खण्ड (स) :** आर्थिक नियोजन: सैद्धान्तिक विवेचन **खण्ड (द) :** भारत में आर्थिक आयेजना **खण्ड (क) :** विदेश में आर्थिक नियोजन ● रूस में आर्थिक नियोजन ● फ्रांस में आर्थिक नियोजन

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