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Strategic parameters for capital budgeting when abandonment value is stochastic

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Abstract

This paper investigates how capital budgeting techniques that include the option to abandon can be exploited as management tools to aid not only in the invest/abandon decision but also in ongoing project management, financial forecasting and the timing of strategic moves. Three parameters are highlighted — the expected growth rate of the salvage value, the volatility of percentage changes in the salvage value and its correlation with the rate of return on the investment itself. Two of these parameters, volatility and correlation, interact with the volatility of the return on the investment in surprising ways, with increases at first decreasing the option value up to a critical point and increasing it thereafter. This insight has implications for the decision making process. Finally, it is shown how the model can be applied in practice to the capital budgeting process, including investment and disinvestment. It is also shown as to how the model can be used as a management tool for financial planning, monitoring ongoing investments, and for the timing of strategic moves.

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