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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 and incremental ways. The paper also discusses the critical point in the investment process. The paper concludes with some implications for capital budgeting and ongoing project management.

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